TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1952

No. 51

F. DONALD ARROWSMITH AND RUTH R. BAUER, EXECUTORS OF THE LAST WILL AND TESTAMENT OF FREDERICK R. BAUER, DECEASED, AND RUTH BAUER, ET AL., PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED MAY 6, 1952

CERTIORARI GRANTED JUNE 9, 1952

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 51

F. DONALD ARROWSMITH AND RUTH R. BAUER, EXECUTORS OF THE LAST WILL AND TESTAMENT OF FREDERICK R. BAUER, DECEASED, AND RUTH BAUER, ET AL., PETITIONERS,

vs.

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INDEX

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—2472

[fol. 1] [File endorsement omitted]

IN THE TAX COURT OF THE UNITED STATES

Appendix to Brief for Appellant—Filed August 6, 1951

Docket No. 24393

FREDERICK R. BAUER and RUTH BAUER, Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DOCKET ENTRIES

1949

Aug. 3. Petition received and filed. Taxpayer notified. Fee paid.

Aug. 4. Copy of petition served on General Counsel.

Sep. 12. Answer filed by General Counsel.

Sep. 13. Request for Hearing in New York filed by General Counsel.

Sep. 21. Notice issued placing proceeding on New York calendar. Service of answer and request made.

1950

Mar. 29. Hearing set May 22, 1950—New York.

May 22. Hearing had before Judge Van Fossan on merits, consolidated with Dk. No. 24394 for hearing. Stipulation of facts with joint exhibits 1-A thru 6-F attached filed. Briefs, July 21, 1950. Replies Aug. 7, 1950.

Jun. 15. Transcript of Hearing 5/22/50 filed.

Jul. 13. Motion for leave to reopen and file supplemental stipulation of facts, supplemental stipulation of facts lodged, filed by petitioner. Granted Aug. 7, 1950.

Jul. 21. Brief filed by taxpayer. Copy served 7/24/50.

Jul. 21. Brief filed by General Counsel.

Dec. 14. Findings of fact and opinion rendered. Van Fossan J. Decision will be entered under Rule 50. Copy served.

[fol. 2] 1951

Jan. 19. Agreed computation for entry of decision filed.

Jan. 23. Decision entered. Van Fossan, J. Div. 9.

Apr. 18. Petition for review by U. S. Court of Appeals for the Second Circuit filed by General Counsel.

Apr. 18. Notice of filing petition for review sent to George R. Sherriff, taxpayer's counsel.

Apr. 30. Proof of service of petition for review filed by General Counsel.

May 18. Motion for extension to July 17, 1951 to prepare and transmit the record filled by General Counsel.

May 18. Order enlarging time to July 17, 1951 to prepare and transmit the record entered.

Jun. 25. Statement of Points filed by General Counsel with statement of service thereon.

Jun. 25. Designation of record filed by General Counsel with statement of service thereon.

Jun. 29. Certified copy of an order from the Second Circuit consolidating dockets 24393 and 24394 for the purpose of sending up a single record and that the exhibits A-1 thru 6-F be transmitted in original form to the Clerk of the U. S. Court of Appeals ten days prior to hearing filed.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 24394

MARY STEWART VIVIAN, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DOCKET ENTRIES

1949

Aug. 3. Petition received and filed. Taxpayer notified. Fee paid.

Aug. 4. Copy of petition served on General Counsel.

Sep. 13. Answer filed by General Counsel.

[fol. 3] 1949

Sep. 13. Request for Hearing in New York filed by General Counsel.

Sep. 21. Notice issued placing proceeding on New York calendar. Service of answer and request made.

1950

Mar. 29. Hearing set May 22, 1950, New York.

May 22. Hearing had before Judge Van Fossan on merits, consolidated with Dk. No. 24393 for hearing. Stipulation of facts with joint exhibits 1-A thru 6-F attached, filed. Briefs, July 21, 1950. Replies Aug. 7, 1950.

June 15. Transcript of Hearing 5/22/50 filed.

Jul. 13. Motion for leave to reopen and file supplemental stipulation of facts, supplemental stipulation lodge, filed by petitioner. Granted 8/7/50.

Jul. 21. Brief filed by taxpayer. Copy served.

Jul. 21. Brief filed by General Counsel.

Dec. 14. Findings of fact and opinion rendered. Van Fossan, J. Decision will be entered under Rule 50. Copy served.

1951

Jan. 19. Agreed computation for entry of decision filed.

Jan. 23. Decision entered. Van Fossan, J. Div. 9.

Apr. 18. Petition for Review by U. S. Court of Appeals for the Second Circuit filed by General Counsel.

Apr. 18. Notice of filing petition for review sent to George R. Sherriff, taxpayer's counsel.

Apr. 30. Proof of service of petition for review filed by General Counsel.

May 18. Motion for extension to July 17, 1951 to prepare and transmit the record filed by General Counsel.

[fol. 4]

May 18. Order enlarging time to July 17, 1951 to prepare and transmit the record entered.

Jun. 25. Statement of points filed by General Counsel with statement of service thereon.

Jun. 25. Designation of record filed by General Counsel with statement of service thereon.

1951

Jun. 29. Certified copy of an order from the Second Circuit consolidating dockets 24393 and 24394 for the purpose of sending up a single record and that the originals of exhibits A-1 thru 6-F be transmitted to the Clerk ten days prior to the hearing filed.

Findings of Fact and Opinion of the Tax Court

(Caption omitted)

The respondent determined deficiencies in the petitioners' income tax liabilities for the year 1944 as follows:

Docket No.	Petitioner	Amount
24393	Frederick R. and Ruth R. Bauer	$14,251.41
24394	Mary Stewart Vivian	8,057.10

The issue is whether a judgment paid by petitioners for a liquidated corporation, of which they were transferees, was a capital loss or an ordinary loss to them in the year of payment.

The proceedings were consolidated and submitted on a stipulation of facts, with exhibits attached. The stipulated facts are so found and are incorporated herein by this reference.

Findings of Fact

Petitioner, Mary Stewart Vivian, is an individual residing in Plainfield, New Jersey, and her income tax return [fol. 5] for the year 1944 was filed with the collector of internal revenue for the second district of New York. She was the wife of Davenport Pogue, who died on September 17, 1937. She married Leslie L. Vivian some time subsequent to 1940.

Petitioners, Frederick R. Bauer and Ruth R. Bauer, are husband and wife, residing at Lakeville, Connecticut. Their joint return for the year 1944 was filed with the collector of internal revenue for the second district of New York.

A corporation, known as Bauer, Pogue & Co., Inc., was organized in April 1933 under the laws of the State of Delaware. One-half of the stock of the corporation was

issued to Frederick R. Bauer, and one-half to Davenport Pogue. Upon the death of Davenport Pogue on September 17, 1937, one F. Donald Arrowsmith was appointed executor of his will and the 50 per cent share of the stock of the corporation belonging to Pogue was transferred to his estate.

The corporation began the first of a series of distributions in complete liquidation on or about December 15, 1937, and made further distributions in liquidation in the years 1938, 1939, and 1940. The last of the distributions in complete liquidation was made in 1940. All such distributions were made as follows: one-half thereof to Frederick R. Bauer, petitioner herein, and the other one-half, representing the shares formerly owned by Davenport Pogue, was distributed in 1937 and 1938 to the Estate of Davenport Pogue, deceased, and in 1939 and 1940 to his widow, Mary Stewart Pogue (now Vivian), petitioner herein, as heir of the Pogue estate.

In the case of the 50 per cent interest formerly owned by Davenport Pogue, no report of the liquidating dividend for 1937 was shown in the return of the Estate of Davenport Pogue, deceased, for that year, but the distribution for the [fol. 6] year 1938 was reflected in the income tax return of the Estate of Davenport Pogue, deceased, for that year. For the years 1939 and 1940 the liquidating dividends representing the Pogue interests paid to Mary Stewart Pogue (now Vivian) were reflected in her income tax returns.

The total liquidating distributions paid to each of the petitioners, Vivian and Bauer, during the years 1937 to 1940, inclusive, exceeded the sum of $47,963.25.

On or about June 8, 1939, an action was commenced in the Supreme Court of the State of New York by Adele D. Trounstine as Ancillary Executrix of the Last Will and Testament of one Norman S. Goldberger as plaintiff, against Bauer, Pogue & Co., Inc., Frederick R. Bauer, and F. Donald Arrowsmith as Executor of the Last Will and Testament of Davenport Pogue, as defendants. This proceeding was transferred to the District Court of the United States for the Southern District of New York because of diversity of citizenship. The suit resulted in a judgment in

favor of the plaintiff therein, which decision was subsequently affirmed on appeal by the Circuit Court of Appeals in and for the Second Circuit. *Trounstine* v. *Bauer, Pogue & Co.*, 144 Fed. (2d) 379. Certiorari was thereafter applied for and denied. *Bauer, Pogue & Co.* v. *Trounstine*, 323 U. S. 777.

Thereafter, on December 11, 1944, after the judgment in the above proceeding had become final, each of the petitioners herein, Vivian and Bauer, was required to, and did, pay one-half of the judgment. The net amount of the judgment, after certain credits and adjustments, was in the amount of $95,926.52, inclusive of interests and costs.

The distributions of liquidating dividends of the corporation to petitioner Frederick R. Bauer were reflected in his [fol. 7] income tax returns for the years 1937, 1938, 1939, and 1940 as capital transactions.

The distributions of liquidating dividends of the corporation to the Estate of Davenport Pogue, deceased in 1938, and to Mary Stewart Pogue (now Vivian) in 1939 and 1940, were reflected in the income tax returns of each of the distributees for said years, respectively, as capital transactions.

Petitioners in each case deducted the payment by each of the sum of $47,963.25 as an ordinary loss in their respective income tax returns for the calendar year 1944.

Respondent determined that the payment by each petitioner of the sum of $47,963.25 represented a capital loss deductible as provided by section 117 of the Internal Revenue Code.

Opinion

Van Fossan, *Judge*: The issue is whether the judgment paid by petitioners for the corporation, of which they were transferees, was a capital loss or an ordinary loss to them in the year of payment.

The respondent contends that the payment of the judgment "grew out of, was related to, and took its character from a capital transaction, namely a long-term capital gain * * *."

The respondent is aware that the case of *Stanley*

Switlik[1] appears contrary to his position here but he [fol. 8] contends that the case is distinguishable. The *Switlik* case and others preceding it were concerned with the payment by transferees of the transferor's *taxes*, whereas here, the transferees paid the amount of a *judgment* against their transferor. The respondent does not argue that the case is on that ground so distinguishable nor do we think so. Respondent attempts, however, to distinguish the *Switlik* case on the basis of circumstances surrounding the payment of the judgment. He points out that the petitioners were aware of the liquidation, that the payment of the resulting judgment might have been made before the last dividend in liquidation was paid and concludes that the judgment payments "cannot be disassociated in their ultimate character from the distributions in liquidation which such payments would have served to diminish." We fail to see a difference in principle between knowledge by transferees that they would be held on a judgment against their transferor and knowledge that a tax deficiency might be assessable against them.

Respondent contends further that the liquidation dividends were charged with a trust in favor of creditors and petitioners did not receive them "under claim of right and without restriction" as in the *Switlik* case. This trust fund theory lends no support to respondent's position. Insolvency, rather than knowledge of liquidation, is, by the general rule, the basis for the application of the trust fund doctrine, Mertens, The Law of Federal Income Tax-

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[1] 13 T. C. 121, affd. (CA-3), 184 Fed. (2d) 299.

The stockholders of a corporation received distributions in complete liquidation in 1941 and each reported his pro rata share in his income tax return for that year as a long term capital gain. In 1944 the stockholders paid their liability as transferees for deficiencies in tax which the Commissioner, in 1942, determined the corporation owed for the years 1940 and 1941. It was held that the losses sustained by the stockholders as a result of payments made in 1944 were deductible in that year as ordinary losses and not as capital losses.

ation, Section 53.37, and insolvency of the transferor is not an element in this case. The respondent states that the petitioners as transferees "made no attempt to provide for this liability" and that a complete liquidation was made "leaving no assets in the hands of the corporation with which to meet the obligation" for the judgment. The [fol. 9] petitioner points out that under the provisions of section 115 (c) as it existed prior to the 1942 Act, the distributions could not be postponed but must be completed in 2 years in order to qualify as capital gains.

The respondent's remaining contentions reiterate his premise that the payment of the judgment was such a part of the capital transaction that it should not be regarded as an ordinary loss. Unless we regard the payment of a judgment as different in principle from a payment of taxes, this argument is to no avail and the issue is disposed of by the *Switlik* case. We see no need to revive or repeat the arguments raised therein since we are of the opinion that the case is not distinguishable. Any other view would multiply gossamer distinctions and ignore the harmonizing principle. Cf. *Roberta Pittman,* 14 T. C. 449, and *Seth M. Milliken,* 15 T. C. 243.

We hold that the payment by petitioners of the amount of a judgment against a corporation of which they were transferees was an ordinary loss to them in the year of payment.

Decisions will be entered under Rule 50.

In the Tax Court of the United States

Docket No. 24393

Frederick R. Bauer and Ruth R. Bauer, Husband and Wife, Petitioners,

v.

Commissioner of Internal Revenue, Respondent

Decision—Entered January 23, 1951

Pursuant to the Findings of Fact and Opinion of the Court promulgated December 14, 1950, the parties herein

having filed an agreed computation of tax on January 19, 1951, it is

[fols. 10-11] Ordered and Decided: That there is a deficiency in income tax for the taxable year 1944 in the amount of $292.12.

(Signed) Ernest H. Van Fossan, Judge.

Docket No. 24894

Mary Stewart Vivian, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Decision—Entered January 23, 1951

Pursuant to the Findings of Fact and Opinion of the Court promulgated December 14, 1950, the parties herein having filed an agreed computation of tax on January 19, 1951, it is

Ordered and Decided: That there is no deficiency in income tax for the taxable year 1944.

(Signed) Ernest H. Van Fossan, Judge.

[fol. 12]

Appendix To Brief For Respondent—Filed September 11, 1951

In the Tax Court of the United States

Opening Statement on Behalf of Taxpayers

(Respondents on Appeal).

Mr. Sheriff: Now, if your Honor please, these two cases both involve the same question. The issue is narrow. In each case the petitioner had to pay a judgment. Each paid one half of a certain judgment, arising out of the operation of a brokerage account. There is no question of the amount of the judgment. There is no question that each paid that judgment. There is no question that it is an allowable loss

to each one. The only question is whether it is a capital loss, rather than the ordinary loss which was claimed on the respective returns.

* * * * * * *

Now, in 1939, that is two years after Mr. Pogue died, but about two years before liquidation had been completed, though it had been started, a suit was started against Bauer, Pogue and Company, against Frederick R. Bauer, and against the Davenport Pogue estate, for an accounting by reason of the operation of a certain stock trading account. It was started by the executor of Norman Goldberger, deceased. The action was started in the Supreme Court of New York. Because of diversity of citizenship it was transferred to the Southern District Court of the Southern District of New York. The action was contested, and resulted after long proceedings in a judgment in favor of the plaintiff in that case. That suit was later appealed to the Circuit Court of Appeals and the judgment was affirmed. After that, an appeal or application was made to the Supreme Court for *certiorari*, which was denied in 1944. At that point of course the judgment became final and each petitioner, that is, Mr. Bauer and Mrs. Vivian, were required to pay one half of the judgment—I will give approximate figures—the judgment was approximately $96,000, and when the judgment became final, Mr. Bauer [fol. 13] and Mrs. Vivian each had to pay approximately one half, or $48,000.

They claimed the losses in their 1944 returns as ordinary losses from transactions entered into for profit, and while there is no question of the amount, or that they are entitled to the losses, the Government now says that they are only capital losses and not ordinary losses, because in earlier years they had been reflected in returns as capital gains, or capital transactions, and therefore in the later years, when the judgment had to be repaid, the Government seeks to limit them to capital loss.

Now, the petitioners' position is simply that this was a transaction entered into for profit, and that the way the matter was reported in the earlier years has no bearing upon the present year. Each year stands by itself. This

Court has already passed on the identical question in the case of *Stanley Switlik*, 13 T. C. 121, where it was held that the payment of the liability of the corporation in the latter year was an ordinary loss, even though the gain on the liquidation in earlier years had been reported as capital gain. That case, incidentally, was reviewed by the Court. I think there was one dissent, but not by your Honor. The case is now pending in the third Circuit, so far as I am advised, and has not been decided.

We submit that each year is entirely a separate transaction, as the Court held in the *Switlik* case and that the prior reporting has no bearing on the situation.

Official Report of Proceedings before the Tax Court of the United States, pages 3, 5, 6.

(File endorsement omitted.)

[fol. 14] IN THE TAX COURT OF THE UNITED STATES

OPENING STATEMENT ON BEHALF OF COMMISSONER

(PETITIONER ON APPEAL).

Mrs. Carlsen: Your Honor, as far as Respondent is concerned, Petitioners' counsel has made a fairly complete statement of our problem. The question in each case is whether the Commissioner erred in disallowing as an ordinary loss the payment by each petitioner in 1944 of one half of a judgment, which was rendered against a corporation, of which each petitioner was the distributee of half of the assets. Respondent has treated these transactions as a capital loss, as Petitioners' counsel has stated.

The evidence shows that Petitioner Bauer reported his liquidating dividends from 1937 to 1940 as capital gains in his income tax returns, and in the case of Mrs. Vivian, she and her predecessor, her deceased husband's estate, likewise reported these liquidated dividends as capital transactions.

It is Respondent's contention in each instance that the taxpayer has merely sustained a capital loss; that the pay-

ment in each case grew out of and was related to and took its character from the original capital transaction; that actually it amounted to nothing more than a diminution of the original liquidating dividend and should be treated in the same manner. We wish to call your Honor's attention to the fact that the suit against the corporation and against Mr. Bauer was instituted before the liquidating dividends were completely distributed and of course in the event that it had gone to judgment these payments would have been deducted, and each of these petitioners would have received accordingly less amount to report as a capital gain.

However, it happens that the case dragged on and on and went through several courts and it was not finally terminated until the year 1944, but both of the parties in [fol. 15] this case, or in this consolidated action, were very well aware that this action was pending, and nevertheless proceeded to continue their distribution of the dividends.

Respondent's contention is based on a trust fund doctrine, which was ruled* on by this Court in Hal C. Smith, 1948 case, 11 T. C. 174, wherein this Court held that a transferee of assets receives these assets from the transferor, impressed with a trust for the benefit of the transferor's creditors. Now, we feel that this position was not perhaps pressed upon the court, or was not at least considered in the opinion of this *Switlik* case and we do concede that the facts are very much within that decision, and that the decision is against the Government, but we have not acquiesced in it and the case is on appeal. We feel that especially in this case, where the petitioners knew that this action was pending against them and that it might go against them, and they proceeded nevertheless over a period of years to completely liquidate a corporation, that they are more specially impressed with the trust than was perhaps the case in this *Switlik* case, and that they can not now say that it was just an ordinary loss.

Official Report of Proceedings before the Tax Court of the United States, pages 8, 9, 10.

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* Erroneously transcribed as "rebid".

[fol. 16] IN THE TAX COURT OF THE UNITED STATES

(FROM DEFICIENCY NOTICE ATTACHED TO PETITION IN BAUER CASE, DOCKET NO. 24393)

* * * * * * *

Adjustments to Net Income

Net income as disclosed by return		$ 1,070.73
Unallowable deductions and additional income:		
(a) Judgment loss	$47,963.27	
(b) Farm loss	1,400.00	
(c) Medical expenses	486.66	49,849.93
Total		$50,920.66
Nontaxable income and additional deductions:		
(d) Capital gain	$17,627.31	
(e) Contributions	634.08	18,261.39
Net income as adjusted		$32,659.27

Explanation of Adjustments

(a) In your return you deducted as an ordinary loss $47,963.27, representing the payment of a judgment. It is determined that this loss represents a capital loss, deductible as provided by Section 117 of the Internal Revenue Code.

* * * * * * *

(d) As a result of adjustment (a), *supra*, the net capital gain of $16,627.31 reported in Schedule D of your return has been adjusted to an allowable net capital loss of $1,000.00, determined as follows:

Net capital gain as disclosed by return	$16,627.31

Deduct:

Long-term capital loss allowed for the reason stated in adjustment (a), *supra* (50% of $47,963.27)	$23,981.64	

Add:

Decrease in capital loss carry-over resulting from decrease in capital loss claimed on return filed by Frederick R. Bauer in respect of the year 1942	917.22	23,064.42
Net capital gain corrected to net capital loss		$ 6,437.11
Limited capital loss allowable under section 117 (d) (2) of the Internal Revenue Code		$ 1,000.00
Net capital gain as disclosed by return		16,627.31
Decrease in income		$17,627.31

* * * * * * *

[fol. 17] IN THE TAX COURT OF THE UNITED STATES

(FROM DEFICIENCY NOTICE ATTACHED TO PETITION IN VIVIAN CASE, DOCKET NO. 24394)

* * * * * * *

Adjustments to Net Income

Net income as disclosed by return		$(12,864.39)
Unallowable deductions and additional income:		
(a) Judgment loss	$47,963.25	
(b) Rental loss	333.33	
(c) Medical expenses	719.23	49,015.81
Total		$ 36,151.42

Nontaxable income and additional deductions:		
(d) Capital gain	$13,990.46	
(e) Contributions	350.00	14,340.46
Net income as adjusted		$ 21,810.96

Explanation of Adjustments

(a) In your return you deducted as an ordinary loss $47,963.25, representing the payment of a judgment. It is determined that this loss represents a capital loss, deductible as provided by Section 117 of the Internal Revenue Code.

* * * * * * *

(d) As a result of adjustment (a), *supra*, the net capital gain of $12,990.46 reported in Schedule D of your return has been adjusted to an allowable net capital loss of $1,000.00, determined as follows:

Net capital gain as disclosed by return	$ 12,990.46
Less: Long-term capital loss allowed for the reason stated in adjustment (a), *supra* (50% of $47,963.25)	23,981.63
Net capital gain corrected to net capital loss	$ 10,991.17
Limited capital loss allowable under section 117 (d) (2) of the Internal Revenue Code	$ 1,000.00
Net capital gain as disclosed by return	12,990.46
Decrease in income	$ 13,990.46

* * * * * * *

[fol. 17a] THE TAX COURT OF THE UNITED STATES

Docket No. 24394

MARY STEWART VIVIAN, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24393

FREDERICK R. BAUER and RUTH R. BAUER, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

STIPULATION OF FACTS—Filed May 22, 1950

It is hereby stipulated and agreed by and between the parties, by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be true:

1. Petitioner Mary Stewart Vivian is an individual residing at 789 Belvidere Avenue, Plainfield, New Jersey. Her income tax return for the year 1944 was filed with the Collector of Internal Revenue for the Second District of New York. A photostatic copy of said return is attached hereto marked Ex. 1-A, and by this reference made a part hereof. Said petitioner was the wife of Davenport Pogue who died on September 17, 1937. She married Leslie L. Vivian some time subsequent to 1940.

2. Petitioners Frederick R. Bauer and Ruth R. Bauer are husband and wife, residing at Lakeville, Connecticut. Their joint return for the year 1944 was filed with the Collector of Internal Revenue for the Second District of New York. A photostatic copy of said return is attached hereto marked Ex. 2-B and by this reference made a part hereof.

[fol. 17b] 3. A corporation known as Bauer, Pogue and Co., Inc. was organized in April of 1933 under the laws of the State of Delaware. One-half of the stock of said corpo-

ration was issued to Frederick R. Bauer, and one-half thereof to Davenport Pogue. Upon the death of said Davenport Pogue on September 17, 1937, one F. Donald Arrowsmith was appointed executor of his Last Will and Testament, and the 50% share of the stock of said corporation belonging to said decedent was transferred to the Estate of Davenport Pogue, Deceased.

4. Said corporation began the first of a series of distributions in complete liquidation on or about December 15, 1937, and made further distributions in liquidation in the years 1938, 1939 and 1940. The last of said distributions in complete liquidation was made in 1940. All such distributions were made as follows: one-half thereof to Frederick R. Bauer, petitioner herein, and the other one-half, representing the shares formerly owned by Davenport Pogue were distributed in 1937 and 1938 to the Estate of Davenport Pogue, Deceased, and in 1939 and 1940 to his widow, Mary Stewart Pogue (now Vivian), petitioner herein, as heir of said estate.

5. Said distributions for the years 1937, 1938, 1939 and 1940 to Frederick R. Bauer were reflected in the income tax returns of said petitioner for those years. Photostatic copies of said returns of Frederick R. Bauer for 1937, 1938, 1939 and 1940 are attached hereto marked Ex. 3-C, and by this reference made a part hereof.

6. In the case of the 50% interest formerly owned by Davenport Pogue, no report of the liquidating dividend for 1937 was shown in the return of the Estate of Davenport Pogue, Deceased, for said year. For the year 1938, the distribution made in said year was reflected in the income tax return of the Estate of Davenport Pogue, Deceased. A photostatic copy thereof is attached hereto marked Ex. 4-D and by this reference made a part hereof. For the years 1939 and 1940 the liquidating dividends representing the Pogue interests paid to Mary Stewart Pogue (now Vivian) were reflected in her income tax returns. Photostatic copies [fol. 17c] of said returns are attached hereto marked Ex. 5-E and by this reference made a part hereof.

7. The total liquidating distributions paid to each petitioner herein during the years 1937 to 1940, inclusive, exceeded the sum of $47,963.25.

8. On or about June 8, 1939, an action was commenced in the Supreme Court of the State of New York by Adele D. Trounstine as Ancillary Executrix of the Last Will and Testament of one Norman S. Goldberger as plaintiff, against Bauer, Pogue & Co., Inc., Frederick R. Bauer, and F. Donald Arrowsmith as Executor of the Last Will and Testament of Davenport Pogue as defendants, which said action was thereafter transferred to the District Court of the United States for the Southern District of New York because of diversity of citizenship. Said action resulted in a judgment in favor of the plaintiff therein, which decision was subsequently affirmed on appeal by the Circuit Court of Appeals in and for the Second Circuit. (Troustine v. Bauer, Pogue & Co., (CCA-2, 1944) 144 F. (2d) 379.) Certiorari was thereafter applied for and denied (Bauer, Pogue & Co., Inc. v. Trounstine, (1944) 323 U. S. 777). A copy of the transcript of the record in said proceeding is attached hereto marked Ex. 6-F and by this reference made a part hereof.

9. Thereafter, on December 11, 1944, after the judgment in said proceeding had become final, each of the petitioners herein was required to, and did pay, one-half of said judgment. The net amount of said judgment, after certain credits and adjustments, was in the amount of $95,926.52, inclusive of interest and costs. The payment made by each of petitioners Frederick R. Bauer and Mary Stewart Vivian was the sum of $47,963.25.

10. Each of the petitioners herein incurred medical expenses in the amounts set forth in their income tax returns for 1944.

(S.) George R. Sheriff, Counsel for Petitioners;
Charles Oliphant, Chief Counsel, Bureau of Internal Revenue.

[fol. 18] United States Court of Appeals for the Second Circuit, October Term, 1951

Nos. 78-79

(Argued December 11, 1951. Decided January 10, 1952)

Docket Nos. 22077-22078

[Title omitted]

Before Chase, Clark and Frank, Circuit Judges

Petition to review a decision of the Tax Court of the United States. Reversed.

[fol. 19] Theron Lamar Caudle, Ellis N. Slack, Helen Goodner and Edward J. P. Zimmerman (argued by Morton K. Rothschild) for petitioner;

George R. Sherriff for respondents.

The facts and decision of the Tax Court are reported in 15 T. C. 876.

Opinion—January 10, 1952

Frank, Circuit Judge:

The liabilities which, in 1944, the taxpayers incurred under the judgment and paid, were directly related to—and would not have existed except for—the capital distributions made by the corporation to those taxpayers in earlier years. Those liabilities, in other words, represent "merely diminution in the capital gain received on the distribution" theretofore made.[1] The two are tied together, and therefore the deductions in 1944 should be treated as capital losses.

In so holding, we disagree with *Commissioner* v. *Switlik*, 184 F. (2d) 299 (C. A. 3). The court there, relying on *North American Oil Consolidated Co.* v. *Burnet*, 286 U. S. 417, rested its decision on what has been called "the theory

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[1] See Judge Disney, dissenting, in *Switlik* v. *Commissioner*, 13 T. C. 121, 127-128.

of the single year as the unit of taxation''[2] and the resultant principle that a tax return for a previous year may not be reopened to reflect a subsequent fact. But we think that this now well-settled principle[3] does not mean that [fol. 20] an examination of the previous year's return may not be made in order to determine the nature of the new fact for the purpose of ascertaining how a gain or loss is to be categorized in computing taxable income for the year in which the new fact happened.[4] So here, considering together the events of the previous year and of the taxable year, the loss in the taxable year show up as arising out of a ''sale or exchange.''

2. Bauer argues that his payment of half the judgment was fully deductible, in any case, because made pursuant to a personal judgment against him, which he would have had to pay regardless of any liquidating distributions he received. See *Trounstine* v. *Bauer, Pogue & Co., Inc.*, 144 F. (2d) 379 (C. A. 2). We agree that the payment of a judgment against a corporate officer in these circumstances would ordinarily be deductible as a straight income loss. Here, however, Bauer was also liable, as a transferee, for the amount paid out, and that liability (we have held above) was an integral part of the original liquidation transfer, and so deductible as a capital loss only. We think, therefore, that the accidental fact that Bauer was liable both as an officer and as a transferee, did not give him the option of picking which liability he would satisfy, according to its tax consequences, when, as here, satisfaction of one liability discharged the other. For our purposes, the fact that he was personally liable for the judgment is superfluous; his fundamental position in regard to the 1944 payment was no different from that of the other transferee.

Reversed.

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[2] 64 Harv. L. Rev. 858, 859 (1951).

[3] See, *U. S.* v. *Lewis*, 340 U. S. 590; *Burnet* v. *Sanford & Brooks Company*, 282 U. S. 359; *St. Regis Paper Co.* v. *Higgins*, 157 F. (2d) 884 (C. A. 2) cert. den. 330 U. S. 843.

[4] Cf. *Westover* v. *Smith*, 173 F. (2d) 90 (C. A. 9); *Commissioner* v. *Carter*, 170 F. (2d) 911 (C. A. 2).

[fol. 21] UNITED STATES COURT OF APPEALS

JUDGMENT—Filed January 10, 1952

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

F. DONALD ARROWSMITH, and RUTH R. BAUER, Executors, etc., et al., Respondents

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed in accordance with the opinion of this court.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

Alexander M. Bell, Clerk.

[File endorsement omitted.]

[fol. 22] UNITED STATES COURT OF APPEALS

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

MARY STEWART VIVIAN, Respondent

JUDGMENT—Filed January 10, 1952

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court

of the United States be and it hereby is reversed in accordance with the opinion of this court.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

Alexander M. Bell, Clerk.

[File endorsement omitted.]

[fols. 22-26] PETITION FOR REHEARING COVERING 4 PAGES FILED JANUARY 24, 1952. OMITTED FROM THIS PRINT. IT WAS DENIED, AND NOTHING MORE BY ORDER—FEBRUARY 11, 1952.

[fol. 28] UNITED STATES COURT OF APPEALS

[Title omitted]

ORDER ON REHEARING—Filed February 1952

Per CURIAM:

Harrie B. Chase, U.S.C.J.; Charles E. Clark, U.S. C.J.; Jerome N. Frank, U.S.C.J.

[File endorsement omitted.]

[fol. 29] UNITED STATES COURT OF APPEALS

[Title omitted]

ORDER DENYING REHEARING—Filed February 11, 1952

A petition for a rehearing having been filed herein by counsel for the respondents,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

[File endorsement omitted.]

[fol. 30] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 29] IN THE SUPREME COURT OF THE UNITED STATES

STIPULATION

It is hereby stipulated and agreed between the parties hereto through their respective counsel of record as follows:

1. That the printed record herein shall consist of the record heretofore filed in connection with the petition for writs of certiorari, with the addition of the stipulation of facts which was filed in The Tax Court of the United States and the present stipulation.

2. All of the original exhibits, 1A to 6F inclusive, filed with The Tax Court and referred to in the stipulation of facts, and which were a part of the record on appeal before the United States Court of Appeals, Second Circuit, shall, together with such stipulation of facts, be forwarded by the Clerk of The Tax Court to the Clerk of the Supreme Court of the United States for use in the present proceeding. Either of the parties hereto may refer in his brief to the original exhibits and any other portions of the record filed in the Supreme Court.

George R. Sherriff, Counsel for Petitioners; Philip B. Perlman, Solicitor General, Counsel for Respondent.

[fol. 30] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1951

No. 753

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors, etc., et al., Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI—Filed June 9, 1952

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted. The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1952

Nos. [redacted] 57

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors of the Last Will and Testament of Frederick R. Bauer, Deceased and RUTH R. BAUER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MARY STEWART VIVIAN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

GEORGE R. SHERRIFF,
Counsel for Petitioners,
42 Broadway,
New York 4, N. Y.

INDEX.

CASES CITED.

IN THE

Supreme Court of the United States

OCTOBER TERM 1951

Nos. ....

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors of the Last Will and Testament of FREDERICK R. BAUER, Deceased and RUTH R. BAUER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MARY STEWART VIVIAN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your Petitioners, F. Donald Arrowsmith and Ruth R. Bauer, Executors of the Estate of Frederick R. Bauer, and Ruth R. Bauer, individually, and Mary Stewart Vivian, hereby respectfully request this Honorable Court to issue

writs of certiorari to the United States Court of Appeals for the Second Circuit to review the decision and judgments of that Court which reversed the decisions of the Tax Court of the United States in these proceedings (R., pp. 18, 21, 23).

The Tax Court, Judge Ernest H. Van Fossan presiding, reversed determinations by the Commissioner of Internal Revenue of deficiencies in the Petitioners' income tax liabilities for the year 1944 (R., pages 7-10).

Opinions Below.

The opinion of the Court of Appeals is reported in 193 Fed. (2d) 734, and appears at pages 18 to 20 of the Record.

The findings of fact and opinion of the Tax Court are reported in 15 T. C. 876, and appear at pages 4 to 9 of the Record.

Jurisdiction.

The opinion of the Court of Appeals was entered on January 10, 1952 (R., pp. 21, 23). A Petition for rehearing was filed on January 24, 1952 (R., p. 25), and was denied without opinion on February 11, 1952 (R., p. 30).

The jurisdiction of this Court is invoked under Section 1254 of Title 28, United States Code.

Question Presented.

Where a judgment against Frederick R. Bauer, individually, and a dissolved corporation in which both he and Mary Stewart Vivian had been stockholders was paid equally by Bauer and Vivian, are their resultant losses capital losses?

Summary Statement of Facts.

The facts were fully stipulated and were found by the Tax Court as stipulated (R., pp. 4-7). They may be summarized as follows:

In April, 1933, a corporation known as Bauer, Pogue & Company, Inc. was organized under the laws of Delaware. One-half of the stock thereof was issued to the taxpayer, Frederick R. Bauer, and one-half to Davenport Pogue. Upon the death of Pogue in 1937, F. Donald Arrowsmith was appointed Executor of his will and decedent's 50% share of the stock was transferred to his estate. Taxpayer, Mary Stewart Vivian, is Pogue's widow, she having remarried some time subsequent to 1940. She acquired all of the one-half interest in said stock formerly belonging to Davenport Pogue, Deceased, as heir of his estate.

On or about December 15, 1937, the corporation began a series of distributions in complete liquidation and made further liquidation distributions in 1938, 1939 and 1940. In compliance with Code Section 115(c) the last of the distributions in complete liquidation was made June 5, 1940, within two years after the end of the corporation's fiscal year ended June 30, 1938, within which fiscal year the first of said liquidating dividends was paid. The corporation paid equal sums in liquidation of each one-half stock interest.

The amounts paid in liquidation of the Bauer shares were all paid to taxpayer Frederick R. Bauer. The amounts paid in liquidation of the Pogue shares were paid as follows: the 1937 and 1938 payments were made to the Estate of Davenport Pogue, Deceased, and the 1939 and 1940 payments were made to taxpayer Mary Stewart Pogue (now Vivian).

The total payments in liquidation of each of said one-half stock interests amounted to $251,069.21. Taxpayer Frederick R. Bauer received said full sum in liquidation of his shares. The taxpayer Vivian received in 1939 and 1940 liquidating dividends upon the Pogue shares totalling $144,149.12.

The liquidating distributions paid to Bauer were reflected in his income tax returns for 1937, 1938, 1939 and 1940 as capital transactions.

As to the liquidating dividends paid on the Pogue shares, no report was made in the income tax return of the Estate of Davenport Pogue, Deceased, for that paid in 1937. The liquidation distribution paid in 1938 was reflected as a capital transaction in the income tax return of the Estate of Davenport Pogue for that year. The liquidation distributions paid in 1939 and 1940 were reflected in the income tax returns of Mary Stewart Pogue (now Vivian) as capital transactions.

On or about June 8, 1939, an action was commenced in the Supreme Court of the State of New York by Adele D. Trounstine, as Ancillary Executrix of the Last Will and Testament of one Norman S. Goldberger, as Plaintiff, against Bauer, Pogue & Company, Inc., Frederick R. Bauer and F. Donald Arrowsmith, as Executor of the Last Will and Testament of Davenport Pogue, as Defendants. The suit was for an accounting as a result of operation of a joint trading account for profit. This proceeding was transferred to the District Court of the United States for the Southern District of New York because of diversity of citizenship. F. Donald Arrowship, as Executor of the Estate of Davenport Pogue, was never served with summons. After trial a judgment was entered in favor of the plaintiff against Bauer, Pogue & Company, Inc. and

against taxpayer Frederick R. Bauer, individually. Bauer, Pogue & Company, Inc. and Bauer appealed, and the plaintiff filed a cross appeal, in the United States Court of Appeals for the Second Circuit, which later affirmed the decision. *Trounstine* v. *Bauer, Pogue & Co., Inc.* 144 F. (2d) 379. The Court of Appeals held that there was no error in holding Bauer personally liable and that he was jointly and severally liable with the corporate defendant.

Bauer, Pogue & Company, Inc. and Bauer applied to the Supreme Court of the United States for writ of certiorari which was denied in 1944. *Bauer, Pogue & Company, Inc.* v. *Trounstine* (1944), 323 U. S. 777.

Thereafter, on December 11, 1944, after the judgment in the above proceeding had become final, each of the taxpayers, Vivian and Bauer, was required to and did pay one-half of the judgment. The net amount of the judgment, after certain credits and adjustments, was $95,926.52 inclusive of interest and costs, and each taxpayer paid one-half or $47,963.25 in satisfaction thereof.

In their respective income tax returns for the calendar year 1944 taxpayers deducted said payments of $47,963.25 as ordinary losses.

The Commissioner determined in each case that the judgment loss of $47,963.25 constituted a capital loss deductible as provided by Section 117 of the Internal Revenue Code.

The Tax Court held that the losses from payment of the judgment constitute ordinary losses for 1944, the year of payment [R., p. 9].

The Court of Appeals reversed the Tax Court and held that the payments should be treated as capital losses [R., pp. 19, 20].

Specifications of Error.

The Court of Appeals erred:

1. In reversing the judgments of the Tax Court.

2. In holding that the losses were diminution of capital gains reported in an earlier year and were therefore capital losses arising from a sale or exchange of a capital asset.

3. In finding a fact not found by the Tax Court, namely, that the losses arose from a sale or exchange of a capital asset.

4. In disregarding the well-established rule of annual accounting for income tax purposes.

5. In holding that Bauer's liability would not have existed except for the capital distributions by the corporation.

6. In holding that because he was also liable as a transferee, Bauer's individual liability to pay the judgment was superfluous.

7. In denying Bauer the privilege of paying his liability as an individual rather than as a transferee.

Reasons for Granting the Writs.

1. The opinion of the Court below specifically disagrees and is in direct conflict with that of the Court of Appeals for the Third Circuit in *Commissioner v. Switlik*, 184 Fed. (2d) 299 upon the same question. In that case the taxpayers received a liquidating distribution in 1941

which they reported as long-term capital gain. During 1944 as transferees they paid tax deficiencies assessed against the corporation and reported such payments as ordinary losses deductible in full. The Commissioner characterized the payments as capital losses, deriving their nature from the liquidation in 1941. The Tax Court held that the losses sustained in 1944 were ordinary losses, and the Court of Appeals for the Third Circuit affirmed.

In the present case the Court of Appeals held to the contrary,—that the losses derived their nature from the liquidation in the earlier year, and were therefore capital losses, specifically disagreeing with the Court of Appeals for the Third Circuit.

In the instant case the Tax Court rejected the Commissioner's contention that the *Switlik* case, *supra*, was distinguishable because it involved payment of taxes rather than payment of a judgment, and held that the *Switlik* decision was controlling.

The Court below recognized that the *Switlik* case was not distinguishable, but expressly stated that it disagreed with the decision of the Court of Appeals, Third Circuit (R., p. 19).

In *Seth M. Milliken* (1950), 15 T. C. 243, the Tax Court followed the decision of the Court of Appeals, Third Circuit, in the *Switlik* case, *supra*, and under similar circumstances allowed the taxpayer a deduction of the full amount which he had paid, as transferee, of a tax deficiency against his transferor corporation. On appeal, the Court of Appeals for the Second Circuit reversed the Tax Court holding that the issue is now controlled in the Second Circuit by its decision in the instant case, *Commissioner* v. *Milliken*, Fed. (2d) (C. A. 2), April 10, 1952.

The conflict between the Second and Third Circuits is leading to confusion in other litigated cases. The Tax Court cited the *Switlik* case, *supra*, in allowing the taxpayers deductions for the full amount of corporate taxes which they had paid as transferees following liquidation of the corporations, in the recent cases of *Lamar D. Fain*, 11 TCM 11, (January 10, 1952) and *Frederick M. Paist*, 10 TCM 967, (October 11, 1951). In so doing it also cited its own decisions in the *Miliken* and *Bauer* (present) cases which have now been reversed in the Second Circuit.

The Third Circuit's decision in the *Switlik* case, *supra*, has been followed in *Clifton* v. *Allen*, 101 Fed. Supp. 997, U. S. D. C., M. D. Ga., (January 10, 1952). A similar result was reached in *Eastland* v. *U. S.*, Fed. Supp. , U. S. D. C., W. D. Tex. (December 11, 1951), now on appeal C. A. 5.

2. The opinion below violates the rule of annual accounting. In holding that payment of the judgment in 1944 was an integral part of the original liquidation, the opinion effectively permits the indirect reopening of earlier years' returns and diminution of capital gain from closed transactions therein reported. This is contrary to the established rule of annual accounting, which requires each year to stand upon its own. *U. S.* v. *Lewis*, 340 U. S. 590; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417. If allowed to stand, this opinion may well support efforts to prevent the closing of tax years in order to arrive at ultimate net results.

3. The Court below exceeded its powers of review in finding facts which were neither stipulated nor found by the Tax Court. Its opinion is founded upon its own inde-

pendent finding of fact that "considering together the events of the previous year and of the taxable year, the losses in the taxable year show up as arising out of a 'sale or exchange' " (R., p. 20).

Whether a gain or loss is from a sale or exchange is a question of fact. *Dobson* v. *Commissioner,* 320 U. S. 489. In denying a petition for rehearing (321 U. S. 231), the Supreme Court said:

> * * * "In these two cases the Tax Court held that recoveries by these taxpayers in 1939 did constitute taxable income. It held, also, that the recovery was taxable as ordinary income, despite taxpayers' contention that it should be taxed as capital gain under Section 117 of the Internal Revenue Code. This contention, the petition says, presents questions of law to be determined by this Court, rather than of fact finally to be determined by the Tax Court.
>
> The weakness of taxpayers' position lies in the fact that not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains from 'the sale or exchange' of capital assets. Internal Revenue Code Sec. 117 (2), (3), (4), (5).
>
> We certainly cannot say that the items in question were as matter of law proceeds of the 'sale or exchange' of a capital asset. Harwick asserted a claim, and the three other taxpayers involved in these cases filed suit, against the National City Company, demanding rescission of their purchases of stock. Their claims were compromised or admitted; the taxpayers seek to link the recoveries resulting therefrom with their prior sales of the stock, which resulted in losses. The Tax Court did not find as matter of fact, and we decline to say as matter of law, that such a transaction is a 'sale or exchange' of a capital asset in the accepted meaning of those terms."

Only a loss from the sale or exchange of a capital asset is a capital loss. This necessitates a finding of fact that the loss was from such sale or exchange. The Tax Court made no such finding of fact and the Court of Appeals should not have so found as a matter of law. The record does not support such a finding. The loss here was from payment of the judgment in an accounting suit.

The opinion below states: "that liability (we have held above) was an integral part of the original liquidation transfer". (R., p. 20) It is respectfully submitted this is a finding of fact which was not found by the Tax Court, and is contrary to the stipulated facts. It was stipulated, and the Tax Court found as a fact, that the liquidation was completed in the earlier year 1940.

4. The Court below erroneously disregarded Bauer's personal liability on the judgment, contrary to its own earlier decision.

The Court below held that "the liabilities * * * incurred under the judgment and paid, were directly related to—and would not have existed except for—the capital distributions made by the corporation to those taxpayers in earlier years." (R., p. 19) The same Court had previously held that Bauer was personally liable irrespective of capital distributions, *Trounstine* v. *Bauer, Pogue & Co., Inc.*, 144 Fed. (2d) 379 (C. A. 2), certiorari denied 323 U. S. 777. The two decisions are in conflict.

The opinion of the Court below in the present case is self-contradictory. It holds on the one hand that the liability would not have existed except for the liquidating distributions, and on the other hand recognizes Bauer's personal liability irrespective of liquidating distributions. Bauer had to pay in any event, regardless of receipt of liquidating distributions. The opinion below recognizes that such pay-

ment "would ordinarily be deductible as a straight income loss" but then denied that right because he was also a transferee (R., p. 20). The fact that he also happens to be a transferee is not a ground for denial of that deduction.

Since Bauer was liable both directly and as transferee he should be permitted to pay whichever liability gave him the greatest tax benefit (cf. *Gregory* v. *Helvering,* 293 U. S. 465, 469).

Bauer's liability as a transferee did not nullify his liability as an individual, and the Court below was in error in so holding.

Wherefore, your petitioners respectfully pray that writs of certiorari should be granted.

Respectfully submitted,

George R. Sherriff,
Counsel for Petitioners,
42 Broadway,
New York 4, N. Y.

Supreme Court of the United States

OCTOBER TERM, 1952

No. 51.

F. DONALD ARROWSMITH AND RUTH R. BAUER, EXECUTORS OF THE LAST WILL AND TESTAMENT OF FREDERICK R. BAUER, DECEASED, AND RUTH BAUER, ET AL.,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONERS.

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INDEX.

CITATIONS.

Cases:

* Not officially reported at time of printing this brief. See 1952-2 U. S. T. C. ¶9409.

Supreme Court of the United States

OCTOBER TERM, 1952

No. 51.

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors of the Last Will and Testament of FREDERICK R. BAUER, Deceased, and RUTH BAUER, *et al.*,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONERS.

Opinions Below.

The findings of fact and opinion of the Tax Court are reported in 15 T. C. 876 (R., pp. 4 to 8). The opinion of the Court of Appeals is reported in 193 Fed. (2d) 734 (R., pp. 19 and 20).

Jurisdiction.

The opinion and judgment of the Court of Appeals were entered January 10, 1952 (R., pp. 19-21). A petition for rehearing was denied on February 11, 1952 (R., p. 24). The petition for writs of certiorari was filed on May 6, 1952 and was granted on June 9, 1952 (R., p. 25; 343 U. S. 976). Jurisdiction is conferred on this Court by Sec. 1254 of Title 28, United States Code.

Question Presented.

Where a judgment against Frederick R. Bauer, individually, and a dissolved corporation in which both he and Mary Stewart Vivian had been stockholders was paid equally by Bauer and Vivian, are their resultant losses capital losses?

Statement.

The facts were fully stipulated (R., pp. 16-18) and were found by the Tax Court as stipulated (R., pp. 4-6). They may be summarized as follows:

In April, 1933, a corporation known as Bauer, Pogue & Company, Inc. was organized under the laws of Delaware. One-half of the stock thereof was issued to the taxpayer, Frederick R. Bauer, and one-half to Davenport Pogue. Upon the death of Pogue in 1937, F. Donald Arrowsmith was appointed Executor of his will and decedent's 50% share of the stock was transferred to his estate. Taxpayer, Mary Stewart Vivian, is Pogue's widow, she having remarried some time subsequent to 1940. She acquired all of the one-half interest in said stock formerly belonging to Davenport Pogue, Deceased, as heir of his estate (R., pp. 4, 5, 16, 17).

On or about December 15, 1937, the corporation began a series of distributions in complete liquidation and made further liquidation distributions in 1938, 1939 and 1940. The last of the distributions in complete liquidation was made June 5, 1940, within two years after the end of the corporation's fiscal year ended June 30, 1938, within which fiscal year the first of said liquidating dividends was paid. The corporation paid equal sums in cash in liquidation of each one-half stock interest (R., pp. 5; 17).

The amounts paid in liquidation of the Bauer shares were all paid to taxpayer Frederick R. Bauer. The amounts

paid in liquidation of the Pogue shares were paid as follows: the 1937 and 1938 payments were made to the Estate of Davenport Pogue, Deceased, and the 1939 and 1940 payments were made to taxpayer Mary Stewart Pogue (now Vivian) (R., pp. 5, 17).

The total payments in liquidation of each of said one-half stock interests amounted to $251,069.21. Taxpayer Frederick R. Bauer received said full sum in liquidation of his shares (R., pp. 5, 17; Ex. 3-C). The taxpayer Vivian received in 1939 and 1940 liquidating dividends upon the Pogue shares totalling $144,149.12 (R., pp. 5, 17; Ex. 5-E).

The liquidating distributions paid to Bauer were reflected in his income tax returns for 1937, 1938, 1939 and 1940 as capital transactions (R., pp. 6, 17; Ex. 3-C).

As to the liquidating dividends paid on the Pogue shares, no report was made in the income tax return of the Estate of Davenport Pogue, Deceased, for that paid in 1937 (R., pp. 5, 17). The liquidation distribution paid in 1938 was reflected as a capital transaction in the income tax return of the Estate of Davenport Pogue for that year (R., pp. 6, 17; Ex. 4-D). The liquidation distributions paid in 1939 and 1940 were reflected in the income tax returns of Mary Stewart Pogue (now Vivian) as capital transactions (R., pp. 6, 17; Ex. 5-E).

On or about June 8, 1939, an action was commenced in the Supreme Court of the State of New York by Adele D. Trounstine, as Ancillary Executrix of the Last Will and Testament of one Norman S. Goldberger, as Plaintiff, against Bauer, Pogue & Company, Inc., Frederick R. Bauer and F. Donald Arrowsmith, as Executor of the Last Will and Testament of Davenport Pogue, as Defendants. The suit was for an accounting as a result of operation of a joint trading account for profit. This proceeding was

transferred to the District Court of the United States for the Southern District of New York because of diversity of citizenship. F. Donald Arrowsmith, as Executor of the Estate of Davenport Pogue, was never served with summons. After trial a judgment was entered in favor of the plaintiff against Bauer, Pogue & Company, Inc. and against taxpayer Frederick R. Bauer, individually. Bauer, Pogue & Company, Inc. and Bauer appealed, and the plaintiff filed a cross appeal, in the United States Court of Appeals for the Second Circuit, which later affirmed the decision. *Trounstine v. Bauer, Pogue & Co., Inc.*, 144 Fed. (2d) 379. The Court of Appeals held that there was no error in holding Bauer personally liable and that he was jointly and severally liable with the corporate defendant (R., pp. 5, 6, 18).

Bauer, Pogue & Company, Inc. and Bauer applied to the Supreme Court of the United States for writ of certiorari which was denied in 1944. *Bauer, Pogue & Company, Inc. v. Trounstine* (1944), 323 U. S. 777 (R., pp. 6, 18; Ex. 6-F).

Thereafter, on December 11, 1944, after the judgment in the above proceeding had become final, each of the taxpayers, Vivian and Bauer, was required to and did pay one-half of the judgment. The net amount of the judgment, after certain credits and adjustments, was $95,926.52 inclusive of interest and costs, and each taxpayer paid one-half or $47,963.25 in satisfaction thereof (R., pp. 6, 18).

In their respective income tax returns for the calendar year 1944 taxpayers deducted said payments of $47,963.25 as ordinary losses (R., pp. 6, 16; Exs. 1-A, 2-B).

The Commissioner determined in each case that the judgment loss of $47,963.25 constituted a capital loss deductible as provided by Section 117 of the Internal Revenue Code (R., pp. 13-15).

The Tax Court held that the losses from payment of the judgment constituted ordinary losses for 1944, the year of payment (R., p. 8).

The Court of Appeals reversed the Tax Court and held that the payments were capital losses (R., pp. 19, 20).

A petition for certiorari was filed in the Supreme Court of the United States May 6, 1952 and was granted June 9, 1952 (R., p. 25).

Specifications of Error.

The Court of Appeals erred:

1. In reversing the judgments of the Tax Court.

2. In holding that the losses were diminution of capital gains reported in an earlier year and were therefore capital losses arising from a sale or exchange of a capital asset.

3. In finding a fact not found by the Tax Court, namely, that the losses arose from a sale or exchange of a capital asset.

4. In disregarding the well-established rule of annual accounting for income tax purposes.

5. In holding that Bauer's liability would not have existed except for the capital distributions by the corporation.

6. In holding that because he was also liable as a transferee, Bauer's individual liability to pay the judgment was superfluous.

7. In denying Bauer the privilege of paying his liability as an individual rather than as a transferee.

Summary of Argument.

1. There was no sale or exchange in 1944, and therefore the admitted losses were not capital losses.

2. The liquidation was a closed transaction in 1940, and under the rule requiring annual tax accounting the losses sustained in 1944 are not a mere diminution of the gains from the liquidation in earlier years.

3. Bauer's personal liability under the judgment did not arise through receipt of liquidating dividends and therefore his loss from payment of the judgment is not to be limited because he also happened to receive liquidating dividends. His personal liability is not nullified because he was also a transferee.

POINT I.

There was no sale or exchange in 1944 and therefore the admitted losses were not capital losses.

The Commissioner determined that the taxpayers were entitled to a deduction in their 1944 returns for losses resulting from payment of the judgment, the amount of which is not in dispute (R., pp. 13-15). The only question is whether said losses are capital losses limited by I. R. C. Section 117 (App., pp. 21, 22).

By its own terms Section 117 applies only if the losses result from a sale or exchange of a capital asset. If there was no such sale or exchange, the losses admittedly are ordinary losses, deductible in full. The only problem is whether Section 117 applies so as to limit the losses.

In applying Section 117 the Court below disregarded the fundamental necessity for a sale or exchange resulting in the loss.

There was in fact no sale or exchange in 1944, and Section 117 by its own terms is inapplicable. The Tax Court, which is the trier of the facts, did not find that the loss was from a sale or exchange.

The identical problem was involved in *Commissioner* v. *Switlik* (1950), C. A. 3, 184 Fed. (2d) 299. In a well reasoned opinion the Third Circuit found that because there was no sale or exchange in the taxable year Section 117 was inapplicable. In so holding the Third Circuit gave full regard to the rule of annual accounting for tax purposes and treated the liquidation in a prior year as a closed transaction.

In the present case (R., pp. 6, 7) and others the Tax Court has consistently followed the *Switlik* decision.

> *Seth M. Milliken* v. *Commissioner* (1950), 15 T. C. 243; reversed (1952), C. A. 2, 196 Fed. (2d) 135; certiorari applied for July 9, 1952, Docket No. 185;
>
> *Lamar D. Fain* v. *Commissioner* (1952), 11 T. C. M. 11 (On appeal C. A. 5);
>
> *Frederick M. Paist* v. *Commissioner* (1951), 10 T. C. M. 967 (On appeal C. A. 3).

A similar result has been reached in other courts.

> *Clifton* v. *Allen* (1952), U. S. D. C., M. D. Ga., 101 Fed. Supp. 997 (On appeal C. A. 5);
>
> *Eastland* v. *U. S.* (1951), U. S. D. C., W. D. Tex., 103 Fed. Supp. 182 (On appeal C. A. 5).

To the contrary, the Court of Appeals for the Second Circuit in the instant case disagreed with the *Switlik* case, holding that the payment of the judgment, being related to

the corporate liquidation in a prior year, was a mere diminution of the capital gain received in the prior year, and therefore was a capital loss (R., pp. 19-20). Accordingly it reversed the Tax Court's decision in the case at bar and later similarly reversed the Tax Court in the *Milliken* case (C. A. 2, 196 Fed. (2d) 135; certiorari applied for July 9, 1952, Docket No. 185).

In holding that the loss here involved resulted from a sale or exchange the Court below exceeded its powers of review in finding facts which were neither stipulated nor found by the Tax Court. Its opinion is founded upon its own independent finding of fact that "considering together the events of the previous year and of the taxable year, the loss in the taxable year show up as arising out of a 'sale or exchange'" (R., p. 20).

Whether a gain or loss is from a sale or exchange is a question of fact. *Dobson* v. *Commissioner* (1943), 320 U. S. 489. In denying a petition for rehearing (1944), 321 U. S. 231, the Supreme Court said [at pp. 231, 232]:

> * * * "In these two cases the Tax Court held that recoveries by these taxpayers in 1939 did constitute taxable income. It held, also, that the recovery was taxable as ordinary income, despite taxpayers' contention that it should be taxed as capital gain under Section 117 of the Internal Revenue Code. This contention, the petition says, presents questions of law to be determined by this Court, rather than of fact finally to be determined by the Tax Court.
>
> The weakness of taxpayers' position lies in the fact that not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains from 'the sale or exchange' of

capital assets. Internal Revenue Code Sec. 117 (2), (3), (4), (5).

We certainly cannot say that the items in question were as matter of law proceeds of the 'sale or exchange' of a capital asset. Harwick asserted a claim, and the three other taxpayers involved in these cases filed suit, against the National City Company, demanding rescission of their purchases of stock. Their claims were compromised or admitted; the taxpayers seek to link the recoveries resulting therefrom with their prior sales of the stock, which resulted in losses. The Tax Court did not find as matter of fact, and we decline to say as matter of law, that such a transaction is a 'sale or exchange' of a capital asset in the accepted meaning of those terms."

Only a loss from the sale or exchange of a capital asset is a capital loss. This necessitates a finding of fact that the loss was from such sale or exchange. The Tax Court made no such finding of fact and the Court of Appeals should not have so found as a matter of law. The record does not support such a finding. The loss here was from payment of the judgment in an accounting suit.

The opinion below states that payment of the judgment "was an integral part of the original liquidation transfer" (R., p. 20). It is respectfully submitted this is a finding of fact which was not found by the Tax Court, and is contrary to the stipulated facts. It was stipulated, and the Tax Court found as a fact, that the liquidation was completed in the earlier year 1940 (R., pp. 5, 17).

Since the *Dobson* decision the Internal Revenue Code has been amended to the end that the Courts of Appeal have jurisdiction to review decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury"

(Internal Revenue Code Sec. 1141(a) as amended June 25, 1948) (App., p. 22). The Tax Court is still the finder of fact and the Court of Appeals is not entitled to substitute its own findings of fact unless the Tax Court's decision is clearly erroneous. Rule 52 of the Rules of Civil Procedure (App., p. 24); *Burford-Toothaker Tractor Company* v. *Commissioner* (1951), C. A. 5, 192 Fed. (2d) 633.

In *U. S.* v. *Cumberland Public Service Co.* (1950), 338 U. S. 451, decided since the amendment, the problem was factual—was the sale of corporate assets following a corporate liquidation in fact made by the stockholders or by the corporation? Mr. Justice Black, speaking for this Court, said [at p. 456]:

> "Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.*, case we accept the findings of fact of the trial tribunal."

This Court in the *Dobson* case treated the question whether there was a sale or exchange as a question of fact and refused to substitute its judgment for that of the Tax Court in determining the fact. The Court of Appeals for the Second Circuit should similarly have followed the findings of fact of the Tax Court and should not have substituted its own findings of fact as a basis for reversal of the Tax Court.

The losses were not from sale or exchange of a capital asset and therefore Section 117 does not apply.

POINT II.

The liquidation was a closed transaction in 1940, and under the rule requiring annual tax accounting the losses sustained in 1944 are not a mere diminution of the gains from the liquidation in earlier year.

Income taxes are imposable and payable annually upon the basis of transactions in that year. I. R. C. 41, 42(a), 43 (App., pp. 19, 20).

Taxpayers properly reported gains from complete liquidation in prior years, and paid the appropriate taxes. Their good faith and propriety in so doing is unquestioned. Those years are properly closed.

In *North American Oil Consolidated* v. *Burnet*, (1932), 286 U. S. 417, income from sale of oil and gas was received by the taxpayer in 1917 under claim of right, though litigation concerning it was not terminated until 1922. The Supreme Court said [at p. 424]:

> "* * * If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. See *Board* v. *Commissioner of Internal Revenue*, 51 F. (2d) 73, 75, 76. Compare *United States* v. *S. S. White Dental Manufacturing Co.*, 274 U. S. 398, 403. If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare *Lucas* v. *American Code Co.*, *supra*."

The court below has approved the reduction of gains properly reported in earlier years, thus striking a net result over several years. The earlier years may not be reopened. However, the same result has been indirectly accomplished here by treating the later year's losses as capital losses in order to diminish the prior year's gains. This violates the rule of annual accounting.

In *Burnet* v. *Sanford & Brooks Company* (1931), 282 U. S. 359, the taxpayer recovered on a judgment in 1920 for work done in earlier years in which it had sustained losses. The taxpayer attempted to strike a net result over more than one year. It contended it did not have to include the amount of the judgment as income in 1920 because it represented the return of losses sustained in the earlier years. The Supreme Court rejected such contention, saying [at pp. 363, 364, 365, 366]:

> "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.
>
> * * * * * *
>
> "* * * A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction will be a gain or a loss.
>
> "The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation.

It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. * * * If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another."

In *United States* v. *Lewis* (1951), 340 U. S. 490, taxpayer reported a bonus as income in 1944. In a later year it was discovered that the bonus had been erroneously computed, and he was required to make repayment in part. He claimed the right to adjust his income in the earlier year. In denying such right the Supreme Court said [at p. 592]:

> "Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I. R. C. §§41, 42; and see *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363. The 'claim of right' interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, *Law of Federal Income Taxation*, §12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer."

Cf. *U. S.* v. *White Dental Manufacturing Co.* (1927), 274 U. S. 398;

Security Flour Mills Co. v. *Commissioner* (1944), 321 U. S. 281.

In *Osenbach v. Commissioner* (1952), C. A. 4, ... Fed. (2d) ...., the taxpayer received in complete liquidation certain assets of the corporation consisting of claims and other choses in action. Upon his later collection on a portion of the assets the Court denied him the right to treat the profits as capital gain, holding that the prior liquidation was a closed transaction, the profits did not result from a sale or exchange, and the later collections did not take on the nature of a sale or exchange from the prior transaction.

Switlik v. Commissioner (1950), C. A. 3, 184 Fed. (2d) 299, involves the identical question here presented. There each taxpayer, as a stockholder, received liquidating dividents of a dissolved corporation and reported the profit as capital gain. In a later year each was called upon, as a transferee, to pay a tax deficiency of the corporation. Full deduction of such payment was claimed as an ordinary loss. The Commissioner attempted to treat said loss as a capital loss, under contentions identical with those here, but both the Tax Court and the Court of Appeals for the Third Circuit disagreed. The latter said [at p. 302]:

> "The Commissioner concedes that the payments in 1944 do not represent losses from the sale or exchange of capital assets so that the deduction of the amounts paid is determined directly by the capital gains and losses provisions of Section 117 of the Code. He concedes also that a loss deduction is due the taxpayers for the taxable year 1944 under the theory of the cases already cited. Notwithstanding, the Commissioner characterizes the payments as capital losses, deriving their nature from the liquidation in 1941 which is denominated a capital transaction by Section 115(c) of the Code, 26 U. S. C. A. Section 115(c). The Tax Court, adhering to the principle of the taxable year, determined that the

capital transaction was concluded in 1941, when the distributions became the taxpayers' property; that there was no sale or exchange in 1944; and that the losses sustained by the taxpayers as a result of the satisfaction of their liability as transferees, under the circumstances, were ordinary losses in 1944.

"We agree with the holding of the Tax Court. The fact that the transferee liability which occasioned the losses grew out of distributions which resulted in capital gain in 1941 is not alone decisive. '* * * not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains from 'the sale or exchange' of capital assets.' *Dobson* v. *Commissioner,* 321 U. S. 231-232 (1944). Accepting the Commissioner's concessions, as we deem them in accordance with the law, that the pragmatic concept of annual accounting prevails, that a loss deduction is due the taxpayers as a result of the satisfaction of their transferee liability, and that the payments do not represent losses from the sale or exchange of capital assets, we are obliged to follow the language of the Internal Revenue Code. Accordingly, the losses sustained by the taxpayers in 1944 are ordinary losses and may be deducted pursuant to the provisions of Section 23(e)(2)".

The *Switlik* decision is correct. It holds that Section 117 is inapplicable because there was no sale or exchange of a capital asset; it gives full effect to the rule of annual accounting for tax purposes; and it declines to characterize the payment as diminution of capital gain from a closed transaction in a prior year. The Court below, in the present case, erroneously disagreed with the *Switlik* decision (R., p. 19).

Carter v. *Commissioner* (1948), C. A. 2, 170 Fed. (2d) 911, and *Westover* v. *Smith* (1949), C. A. 9, 173 Fed. (2d) 90

cited by the court below, have no application. In those cases the assets received upon liquidation had no readily ascertainable market value. In the *Carter* case the assets were personal service contracts where the personal services had been performed and in the *Smith* case the amounts later received were royalty payments under a contract. The payments received in later years in each of those cases constituted a part of the consideration for the exchange. In those cases the transactions were not closed in the earlier year. On the contrary, in the present case the liquidation was complete and closed in 1940 and the liquidating dividends were paid in cash. Cf. *Osenbach* v. *Commissioner* (1952), C. A. 4, — Fed. (2d) —.

The opinion below sets a precedent which may be harmful to the Revenue. If allowed to stand it may be used as a basis for attempts to hold open tax years to arrive at ultimate net results or to indirectly reopen closed transactions in prior years. This may lead to confusion and litigation and prevent the closing of tax years contrary to the well established rule requiring annual accounting for tax purposes.

The earlier years are properly closed and may not now be reopened, even indirectly, in order to reflect events in subsequent years. The court below recognizes this but says the earlier years are considered in order to categorize the gain or loss in the later year. In holding the 1944 loss to be a capital loss, the court below has simply transposed the sale or exchange (complete liquidation) from 1940 to 1944, which is factually incorrect. Moreover, it is for the Trial Court, not the Appellate Court, to determine the factual category in which the transaction belongs. *Cumberland Public Service Co.* v. *Commission, supra*, p. 10.

POINT III.

Bauer's personal liability under the judgment did not arise through receipt of liquidating dividends and therefore his loss from payment of the judgment is not to be limited because he also happened to receive liquidating dividends. His personal liability is not nullified because he was also a transferee.

The Court below erroneously disregarded Bauer's personal liability on the judgment contrary to its own earlier decision. It held that "the liabilities * * * incurred under the judgment and paid, were directly related to—and would not have existed except for—the capital distributions made by the corporation to those taxpayers in earlier years" (R., p. 19). The same Court had previously held that Bauer was personally liable irrespective of capital distributions, *Trounstine* v. *Bauer, Pogue & Co., Inc.*, 144 Fed. (2d) 379 (C. A. 2), certiorari denied 323 U. S. 777. The two decisions are in conflict.

The opinion of the Court below in the present case is self-contradictory. It holds on the one hand that the liability would not have existed except for the liquidating distributions (R., p. 19), and on the other hand recognizes Bauer's personal liability irrespective of liquidating distributions (R., p. 20).

Bauer had to pay in any event, regardless of receipt of liquidating distributions. The opinion below recognizes that such payment "would ordinarily be deductible as a straight income loss" but then denied that right because he was also a transferee (R., p. 20). The fact that he also happens to be a transferee is not a ground for denial of that deduction.

Since Bauer was liable both directly and as transferee he should be permitted to pay whichever liability gave him the greatest tax benefit. Cf. *Gregory v. Helvering* (1935); 293 U. S. 465, 469.

Bauer's liability as a transferee did not nullify his liability as an individual, and the Court below was in error in so holding.

Conclusion.

The decision of the Court of Appeals that the losses sustained by taxpayers were capital losses is erroneous and should be reversed.

Respectfully submitted,

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Appendix.

Statutes and Regulations Involved.

Internal Revenue Code.

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

(g) Capital Losses.—

(1) *Limitation.*—Loses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

[26 U. S. C. 1946 ed. Sec. 23].

Sec. 41—General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *

[26 U. S. C. 1946 ed. Sec. 41].

Sec. 42(a) [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 688.]—Period in which items of Gross Income included.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

[26 U. S. C. 1946 ed. Sec. 42].

Sec. 43—Period for which Deductions and Credits are taken.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

[26 U. S. C. 1946 ed. Sec. 43].

Sec. 115(c)

[Prior to Amendments made by Revenue Act of 1942] "DISTRIBUTIONS IN LIQUIDATION.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, 'complete liquidation' includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to

which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *"

[26 U. S. C. 1946 ed. Sec. 115].

Sec. 117. CAPITAL GAINS AND LOSSES.

[As amended by Sec. 150(a)(1) and (2), (b) and 151(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798].

(a) DEFINITIONS.—As used in this chapter—

(1) CAPITAL ASSETS.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

(2) SHORT-TERM CAPITAL GAIN.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing net income;

(3) SHORT-TERM CAPITAL LOSS.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income;

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or

exchange of a capital asset held for more than 6 months, if and to the extent such gain taken into account in computing net income;

(5) LONG-TERM CAPITAL LOSS.—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months if and to the extent such loss is taken into account in computing net income;

* * * * * * *

Sec. 117

(b) [As amended by Sec. 150(c) of the Revenue Act of 1942, *supra*]. Percentage Taken into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

(d) LIMITATION ON CAPITAL LOSSES.—

(2) [as amended by Sec. 150(c) of the Revenue Act of 1942 *supra*.] OTHER TAXPAYERS.—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer of $1,000 whichever is smaller. For purposes of this paragraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. * * *

[26 U. S. C. 1946 ed. Sec. 117].

Sec. 1141. COURTS OF REVIEW.

(a) [As amended by Sec. 36 of the Act of June 25, 1948, c. 646, 62 Stat. 869]. JURISDICTION—The courts of appeals shall have exclusive jurisdiction to review the decision of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as

decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code.

[U. S. C. 1946 ed., Supp. II, Sec. 1141].

Regulations 111.

Sec. 29.23(e)-1. LOSSES BY INDIVIDUALS.—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses; section 23(h), relating to wagering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

Rules of Civil Procedure for the District Courts of the United States as Amended.

RULE 52(a)—Findings by the Court.

Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. * * *

Office Supreme Court, U. S.
FILED
MAY 29 1952
CHARLES ELMORE CROPLEY
CLERK

NO. ~~352~~ 57

In the Supreme Court of the United States

OCTOBER TERM, 195~~1~~

F. DONALD ARROWSMITH AND RUTH R. BAUER, Executors of the Last Will and Testament of Frederick R. Bauer, Deceased, and RUTH R. BAUER, ET AL., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MEMORANDUM FOR THE RESPONDENT

In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 753

F. DONALD ARROWSMITH AND RUTH R. BAUER, Executors of the Last Will and Testament of Frederick R. Bauer, Deceased, and RUTH R. BAUER, ET AL., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

MEMORANDUM FOR THE RESPONDENT

The Commissioner does not oppose the granting of a writ of certiorari in the above-entitled consolidated cases limited to the question which is common to the cases.

1. The question common to the two consolidated cases is: Where stockholders realize a capital gain

on the liquidation of a corporation and in a subsequent year are required as transferees to pay a judgment against the corporation, whether the amounts paid in settlement of the transferee liability are to be treated in the year of payment as ordinary loss deductions under Section 23 (e) of the Internal Revenue Code (26 U.S.C. 23) or as capital losses under Section 117 of the Code (26 U.S.C. 117).

The decision of the court below that the amounts paid in settlement of the transferee liability should be treated as capital losses conflicts with the decision of the Third Circuit in *Commissioner* v. *Switlik,* 184 F. 2d 299.

There are a number of other cases involving the same question now pending in the courts. The court below followed its decision in the instant cases in *Milliken* v. *Commissioner,* decided April 10, 1952 (1952 C.C.H. par. 9284), rehearing denied, May 5, 1952. Counsel for the taxpayer in the *Milliken* case stated in the petition for rehearing filed with the Second Circuit that they contemplated filing a petition for a writ of certiorari. The following cases are pending on appeal from various District Courts to the Fifth Circuit:

Clifton v. *Allen,* 101 F. Supp. 997 (M.D. Ga.)

Eastland v. *United States,* 103 F. Supp. 182 (W.D. Tex.)

Roy P. Eastland, Sr., et ux. v. *United States* (N.D. Tex.), decided November 11, 1951.
Roy P. Eastland, Sr. v. *United States* (N.D. Tex.), decided November 11, 1951.

Appeals to the Fifth Circuit from decisions of the Tax Court in *Fain* v. *Commissioner* and *McGaha* v. *Commissioner,* decided January 10, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,004), are also pending.

2. The petitioners' argument (Pet. 10-11) that the court below erroneously disregarded Bauer's personal liability on the judgment raises an issue which is not common to the two consolidated cases; it is an issue that was not involved in *Commissioner* v. *Switlik, supra,* and upon which there is no conflict of decision. Moreover, although Bauer was jointly and severally liable with the corporation on the judgment,* it would seem that the court below was correct in holding that the accidental fact that Bauer was liable as an officer as well as a transferee did not alter the basic fact that he was required to surrender a portion of the assets he had received as a capital distribution. (R. 19.) Under the circumstances, the court below was warranted in concluding that Bauer's fundamental position in regard to the payment in question was no different from that of the other trans-

* *Trounstine* v. *Bauer, Pogue & Co.,* 144 F. 2d 379, 382 (C.A. 2d), certiorari denied, 323 U. S. 777.

feree. (R. 19.) Therefore, we respectfully submit that this particular question should be excluded if the writ is granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

MAY, 1952.

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No. 51

In the Supreme Court of the United States

OCTOBER TERM, 1952

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors of the Last Will and Testament of Frederick R. Bauer, Deceased, and RUTH R. BAUER, *et al.*,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE RESPONDENT

INDEX

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OPINIONS BELOW

The opinion of the Tax Court (R. 4-8) is reported at 15 T. C. 876. The opinion of the Court of Appeals (R. 19-20) is reported at 193 F. 2d 734.

JURISDICTION

The judgments of the Court of Appeals were entered January 10, 1952. (R. 21-22.) A petition for rehearing was denied February 11, 1952. (R. 24.) The petition for a writ of certiorari was filed May 6, 1952, and was granted June 9, 1952. (R. 25.) The jurisdiction of this Court rests on 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

The taxpayers Bauer and Pogue liquidated a corporation of which they were the sole and equal stockholders, and reported the gain from the exchange of their stock for the corporate assets as a long-term capital gain. In a subsequent year they refunded a portion of the amount received on the liquidation, in satisfaction of their transferee liability for a corporate debt. The questions presented are:

1. Was the amount refunded fully deductible as an ordinary loss under Section 23(e) of the Internal Revenue Code, or only in part as a capital loss under Sections 23(g) and 117?

2. As to Bauer, must his share of the refund in any event be treated as an ordinary loss because the creditor obtained a judgment against him as well as against the corporation?

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 44-49.

STATEMENT

The facts as stipulated (R. 16-18) were adopted by the Tax Court as its findings (R. 4-6). They may be summarized as follows:

Petitioners are the successors in interest of Frederick R. Bauer and Davenport Pogue, each of whom owned one-half of the stock of Bauer, Pogue and Company, Inc. (hereafter called the "corporation"). (R. 4-5.) For convenience the term "taxpayer" will be used to denote the original stockholders, Bauer and Pogue.[1]

During the years 1937 to 1940, inclusive, the corporation made a series of liquidation distributions which resulted in its complete liquidation. (R. 5.) In their income tax returns for those years taxpayers reported the distributions as capital gains. (R. 6; Stip. Exs. 3-C, 4-D, 5-E.)[2]

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[1] Pogue died in 1937, and his stock was transferred to his executor and thence to his heir and widow, the petitioner, Mary S. Vivian. Bauer died after the commencement of these proceedings, and is now represented by his executors. Ruth R. Bauer is a petitioner individually because she and her husband filed a joint return for the taxable year. (R. 4-5.)

[2] In each of the years 1938, 1939 and 1940 Bauer reported fifty percent of the gains as long-term capital gains, and for 1937 he reported forty percent. (Ex. 3-C.) Pogue's estate did not report any distribution in its 1937 return (R. 5), and in its 1938 return it reported a short-term capital loss from the distribution (Ex. 4-D). In her 1939 return Vivian reported fifty percent of the gain as a long-term capital gain, and in her 1940 return she reported a long-term capital loss. (Ex. 5-E.) By stipulation of the parties the exhibits to the stipulation of facts have not been printed, but have been transmitted to the Clerk of this Court. (R. 25.)

In 1939, while the liquidation was in process, an action was commenced against the corporation and its stockholders. The action resulted in a judgment against the corporation and against Bauer personally, which was subsequently affirmed on appeal. *Trounstine* v. *Bauer, Pogue & Co.*, 44 F. Supp. 767 (S. D. N. Y.), affirmed, 144 F. 2d 379 (C. A. 2d), certiorari denied, 323 U. S. 777. In 1944, after the judgment became final, each of the taxpayers was required to and did pay one-half of the judgment, or $47,963.25, which amount was less than the liquidation distributions each had received from the corporation. (R. 5-6.) The payments were made in satisfaction of their liability as transferees of the corporate assets. (R. 4, 6.)

In their respective income tax returns for 1944 each of the taxpayers deducted in full as an ordinary loss the amount paid to the judgment creditor of the corporation. The Commissioner determined that the payments represented capital losses, deductible only in part. (R. 6, 13-15.) The Tax Court regarded this case as indistinguishable from *Switlik* v. *Commissioner*, 13 T. C. 121, affirmed, 184 F. 2d 299 (C. A. 3d), and on the basis of its decision in that case held that the payments were deductible as ordinary losses. (R. 6-8.) [3]

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[3] In the *Switlik* case the Tax Court held that post-liquidation payments of a corporate tax indebtedness by stockholders in satisfaction of their transferee liability were deductible as ordinary rather than as capital losses, on the ground that the payments were made in a taxable year subsequent to their receipt of the corporate assets.

The Court of Appeals reversed, holding that the payments were deductible as capital losses. (R. 19-20.)

SUMMARY OF ARGUMENT

I

Section 23(g) of the Internal Revenue Code limits the deduction of losses otherwise allowable under Section 23(e), by providing that losses from sales or exchanges of capital assets (capital losses) are deductible only to the extent allowed in Section 117. The latter section prescribes that only fifty percent of a long-term capital gain or loss shall be taken into account in computing net income. Gains or losses realized by a stockholder from a corporate liquidation are made subject to the capital gain and loss limitations by Section 115(c), which requires that the liquidation distributions be treated as amounts received "in exchange" for the stock.

The court below correctly held that the taxpayers, who realized capital gains upon the liquidation of a corporation of which they were the equal stockholders, sustained capital losses subject to the limitations of Sections 23(g) and 117—not ordinary losses deductible in full under Section 23(e)—when in a later year they refunded a portion of the liquidation proceeds to a judgment creditor of the corporation in satisfaction of their liability as transferees of the corporate assets. The liquida-

tion distributions represented amounts received by taxpayers in exchange for their stock, a capital asset, and resulted in long-term capital gains only a percentage of which they reported in their income tax returns for the years in which the distributions were received. Their transferee liability for the corporate debt flowed solely and directly from, and was an integral part of, the transfer of the corporate assets in exchange for their stock. Their payments in discharge of that liability merely reduced the capital distributions received from the corporation and, correspondingly, the long-term capital gain realized therefrom. The same capital transaction which gave rise to the previously reported capital gain—exchange of stock for corporate assets—also produced the loss in question. That loss, like the previously reported capital gain, resulted "from" the exchange within the meaning of Section 23(g); and that transaction was just as much a capital transaction for purposes of determining the taxpayers' loss as it was for determining their gain.

To treat the post-liquidation payment of a corporate debt by a transferee-stockholder as an ordinary loss deductible in full under Section 23(e) would not only defeat the express limitations of Section 23(g) on capital loss deductions; it would in effect relieve the stockholder of tax on more than fifty percent of the actual gain realized from the exchange of his stock for the corporate assets,

contrary to the mandate of Section 117, by permitting him to deduct one hundred percent of the assets used to satisfy the debt after having taken into account only fifty percent of those assets in computing the capital gain on the exchange. This would open the door to a ready means of tax avoidance by stockholders of a closely held corporation whose assets are subject to outstanding or contingent liabilities at the time of liquidation, especially where as here the stockholders are aware of such liabilities when they receive the corporate assets.

The Tax Court treated the payments as ordinary losses on the theory that, having been made in a taxable year subsequent to the liquidation exchange, the "annual accounting" rule served to sever the connection between the transfer of the corporate assets to the stockholders and their transferee liability for the corporate debts. Nothing in the statute or the decisions warrants such an application of the annual accounting rule, and the court below properly rejected it. The annual accounting concept has reference to *when* an income or deduction item must be accounted for in computing net income, not to whether or to what extent the item enters into the computation. While it prevents the reopening of a past year's tax return in order to reflect subsequent events, it does not preclude examination of past events for purposes of determining the nature and tax effect of a

payment in the current year. Indeed, to disassociate a payment from the underlying transaction which created the liability to pay, merely because the transaction had its inception in an earlier year, would foreclose any inquiry as to the character and deductibility of the payment. Where stockholders receive liquidation distributions in successive years the courts have treated the distributions as interrelated steps of a single capital transaction, resulting in additional capital gain in the later years; conversely, where as here a part of the amount received is surrendered by the stockholders in a later year in discharge of their transferee liability, the portion refunded represents a diminution of the prior capital distributions and is deductible as a capital loss. Had taxpayers made the payments in the same taxable year in which the liquidation distributions were received and reported as long-term capital gains, the payments unquestionably would be deductible as capital losses in that year. They are not transformed into ordinary losses simply because they were made, and are deductible, in a later year.

Taxpayers' contention that the court below disregarded the Tax Court's findings in holding that the payments resulted from the liquidation exchange misconceives the rationale of the Tax Court's decision. The Tax Court recognized that the transferee liability which occasioned the payments arose from the exchange, but erroneously

considered itself precluded as a matter of law—by reason of the annual accounting rule—from relating the transferee liability to the earlier year's exchange.

If the payments are completely disassociated from the prior liquidation exchange, as taxpayers contend, there would seem to be no escape from the paradoxical conclusion, hardly desired by the taxpayers, that no deduction whatsoever could be taken for these losses. Section 23(e) authorizes the deduction of losses incurred in a "transaction entered into for profit", and the only transaction which the record and findings disclose as having created the transferee liability discharged by the payments was the liquidation of the corporation, concededly a capital transaction. Unless the payments are related to that transaction and with the resultant transferee liability, they are not deductible either as capital or ordinary losses.

II

Bauer's payment of one-half of the corporate debt did not differ in nature from Pogue's payment of the other half merely because the creditor obtained a judgment against him personally as well as the corporation. The judgment was obtained in an action brought against the corporation for an accounting of profits realized from a joint venture entered into by the corporation and the plaintiff. Bauer and Pogue were made parties defendant as stockholder-transferees of the corporation and as officers who had mismanaged its af-

fairs; only Bauer was served, however, and he was held jointly liable with the corporation. By paying one-half of the judgment Bauer satisfied his transferee liability as a stockholder, not his tort liability as an officer, and the Tax Court so viewed his payment. Moreover, were Bauer's payment of half of the amount of the judgment viewed as a partial satisfaction of his tort liability for mismanagement of the corporation, it would not be a deductible loss at all. At any rate, as the court below pointed out, Bauer's payment served to extinguish his pro rata transferee liability as a stockholder, and for tax purposes can stand on no different footing from Pogue's payment. Since both courts below regarded Bauer's payment of half of the judgment, like Pogue's payment of the other half, as made in satisfaction of transferee liability, if this Court should take a different view, the case should be remanded for a determination of the nature and deductibility of Bauer's payment.

ARGUMENT

I

The Claimed Deductions Are Allowable as Capital Losses Under Section 23(g) and 117 of the Internal Revenue Code, Not as Ordinary Losses Under Section 23(e)

A. Introductory

These cases present a single question of law arising from an agreed set of facts: Whether a stock-

holder who realizes a capital gain [4] from the exchange of his stock for the corporate assets upon liquidation of the corporation, and in a later year refunds a portion of the liquidation proceeds to a creditor of the corporation in satisfaction of his transferee liability, may deduct the refund payment in full as an ordinary loss under Section 23(e) of the Internal Revenue Code (Appendix, *infra*, p. 44), or is required to treat it as a capital loss deductible only to the extent provided in Sections 23(g) and 117 (Appendix, *infra*, pp. 44, 46-47). Each of the taxpayers made a capital investment represented by one-half of the shares of stock in a corporation. During the years 1937 to 1940, they liquidated the corporation and, pursuant to the provisions of Sections 115(c) (Appendix, *infra*, p. 45) and 117(a) and (b) of the Internal Revenue Code and similar provisions of prior Acts, each reported his gain from the liquidation distributions as long-term capital gain, taking into account only a percentage [5] of the gain in computing his net income. At the time the corporation was liquidated its assets were subject to a contingent liability, of which the taxpayers were aware, and this liability

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[4] See fn. 2, *supra*, p. 3, where it is shown that in the two years 1938 and 1940 one of the stockholders (Pogue and his successor in interest, Vivian) reported a capital loss. However, whether a capital gain or loss is reported, the basic question is the same.

[5] See footnote 2, *supra*.

became absolute in 1944 when a judgment against the corporation became final.[6] In that year taxpayers restored a portion of the liquidation proceeds to the judgment creditor, each paying one-half of the judgment in satisfaction of his pro rata liability as a transferee of the corporate assets. In their income tax returns for 1944 each sought to deduct his payment in full as an ordinary loss under Section 23(e). The Commissioner ruled that the payments were deductible as long-term capital losses under Sections 23(g) and 117(b), only fifty percent of which could be taken into account. (R. 4-6, 13-15; Stip. Exs. 1-A to 5-E.)

Viewing this case as "not distinguishable" from *Switlik* v. *Commissioner,* 13 T. C. 121, affirmed, 184 F. 2d 299 (C. A. 3d), the Tax Court overruled the Commissioner's determination. (R. 8.) In the *Switlik* case the Tax Court held that stockholders who had reported long-term capital gains on the liquidation of a corporation in 1941, and in 1944 paid tax deficiencies of the corporation in satisfaction of their transferee liability, could deduct the full amount of the payment in 1944 as an ordinary loss. It reasoned as follows (13 T. C., at pp. 126-127): (1) Under our system of computing net income by annual accounting periods, each taxable year is a separate unit for tax accounting purposes;

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[6] The suit which culminated in the judgment against the corporation was commenced in 1939, and the liquidation was completed in 1940. (R. 5.)

(2) the liquidation distributions were received and properly reported as long-term capital gains in 1941, while the refund payments in satisfaction of transferee liability were made and properly reported as losses in 1944; (3) therefore, the 1944 losses were ordinary rather than capital losses, "and this is true even though the transferee liability which occasioned the losses arose out of distributions which resulted in capital gains in 1941". The Court of Appeals for the Third Circuit approved this reasoning in affirming the Tax Court's decision in the *Switlik* case. 184 F. 2d 299. The court below, however, while agreeing with the major and minor premises of the syllogism, did not think that the conclusion drawn by the Tax Court was either necessary or justified. (R. 19-20.)

We think the Court of Appeals for the Second Circuit is clearly correct in its analysis of this problem. Agreeing with the dissenting opinion in the *Switlik* case (13 T. C., at pp. 127-128), the court below held that the annual accounting rule does not preclude an examination of transactions or events occurring in a prior year for purposes of determining the *nature* and tax effect of a payment made in a later year; that the payments which taxpayers here made in 1944 and are seeking to deduct as ordinary losses in that year "were directly related to" and "tied together" with the liquidation distributions they reported as long-term capital gains in prior years, and represent merely

"diminution" of those gains; and that "considering together the events of the previous year and of the taxable year, the loss in the taxable year shows up as arising out of a 'sale or exchange'", and hence is deductible as a capital loss. (R. 19-20.)

The taxpayers take the position that the court below erred in relating their transferee liability to the liquidation distributions for purposes of determining whether the payments in satisfaction of that liability represented ordinary or capital losses. They look upon the annual accounting rule as if it required that each tax year must be examined *in vacuo,* like an airtight compartment, and as if it bore no relation whatsoever to events occurring in other tax years. But business transactions carrying tax consequences do not necessarily, or even ordinarily, begin and end within a single tax year. And the court below was plainly right in holding that the annual accounting rule does not mean that in determining whether a transaction gives rise to capital gain or loss in one year, no inquiry can be made as to how the same transaction was treated by the taxpayer and the Commissioner in earlier years.

B. The Relevant Statutory Provisions

Section 115(c) of the Internal Revenue Code provides that "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock" and that

the "gain or loss to the distributee resulting from such exchange shall be determined under section 111". Under the latter section (Appendix, *infra*, p. 45) the gain or loss from the exchange is the difference between the "amount realized" and the "adjusted basis" of the stock;[7] and the "amount realized" is the sum of any money received plus the fair market value of any property received. Section 117 deals specifically with "Capital Gains and Losses".[8] Section 117(a)(1) defines a "Capital Asset" as including property held by the taxpayer whether or not connected with his business, with exceptions not pertinent here; and Section 117(a)(4) and (5) defines a gain or loss "from the sale or exchange of a capital asset held for more than 6 months" as a "long-term" capital gain or loss. Section 117(b) prescribes that only fifty per-cent of a long-term capital gain or loss is to be taken into account in computing net income, and Section 117(d) allows capital loss deductions only to the extent of capital gains with exceptions not

[7] The "basis" of the stock is its "cost" (Section 113(a)), "adjusted" in accordance with the provisions of Section 113(b).

[8] Capital gains and losses, *i.e.*, those resulting from the sale or exchange of a capital asset were first accorded special treatment in Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227. See H. Rep. No. 350, 67th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 168, 176; S. Rep. No. 275, 67th Cong., 1st Sess., p. 12 (1939-1 Cum. Bull. (Part 2) 181, 189. With various modifications, the special treatment of such gains has been a feature of every subsequent Revenue Act.

here material.[9] It is now settled that in requiring liquidation distributions by a corporation to be treated as amounts paid "in exchange" for the stock (Section 115(c)), Congress intended to subject stockholders' gains or losses from corporate liquidations to the statutory conditions and limitations imposed upon capital gains or losses. *White* v. *United States,* 305 U. S. 281; *Helvering* v. *Weaver Co.,* 305 U. S. 293. See also Section 29.115-5 of Treasury Regulations 111 (Appendix, *infra,* pp. 48-49).

Section 23(e)(2) of the Internal Revenue Code authorizes a deduction from gross income of losses sustained during the taxable year, though not connected with the taxpayer's business, "if incurred in any transaction entered into for profit". The deduction authorized by this section is limited, however, by Section 23(g), which provides that "Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117". See also Sections 29.23(e)-1, 29.23(g)-1 and 29.117-2 of Treasury Regulations 111 (Appendix, *infra,* pp. 47, 48, 49). A loss which qualifies for deduction in full under Section 23(e) is an ordinary loss, as distinguished from a capital loss which is subject to the limitations of Sections 23(g) and 117.

[9] Section 117(c) provides for an alternative tax on the excess of net long-term capital gain over net short-term capital loss.

Whether a payment qualifies for deduction as either an ordinary or a capital loss [10] necessarily depends upon the nature of the liability which it extinguishes, which in turn depends upon the nature of the "transaction" from which the liability flows. If the liability is incurred in a "transaction entered into for profit" other than a capital transaction, the payment is deductible as an ordinary loss under Section 23(e). On the other hand, if the transaction which creates the liability is a sale or exchange of a capital asset—a capital transaction—the express limitations of Sections 23(g) and 117 come into play.

C. Taxpayers' Transferee Liability for the Corporate Debt Having Resulted Solely from the Liquidation Exchange of Their Stock for the Corporate Assets (a Capital Transaction). Their Payments in Satisfaction of That Liability Were Capital Losses

Since the liquidation distributions received by taxpayers constitued amounts received in exchange for their stock by virtue of the provisions of Section 115(c), the gains realized from that exchange constituted long-term capital gains taxable only to

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[10] The provisions of Section 23(e) and (g) must of course be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer". *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 593. See also *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *duPont*, 308 U. S. 488, 493; *Boehm* v. *Commissioner*, 326 U. S. 287, 295.

the extent provided in Section 117.[11] Taxpayers so treated the transaction by reporting only a percentage of the gains in their income tax returns for the years in which the liquidation distributions were received. (Stip. Exs. 3-C, 4-D and 5-E.) The losses which they now seek to deduct—amounts refunded to a creditor of the corporation in discharge of their liability as transferees of the corporate assets—resulted solely and directly from the prior exchange and are no less capital in nature than the previously reported gains. The same capital transaction which produced the gains also produced the loss, and as in the case of the previously reported gains only, a percentage of the loss may be taken into account under Section 117(b).

When the assets of a corporation are distributed to its stockholders in liquidation, they are received subject to the corporate liabilities, existing and potential. If the transferee-stockholders do not expressly assume the corporate debts, they are by operation of law obliged to satisfy them. It has long been settled that "if the assets of a corporation are distributed among the stockholders before all its debts are paid, each stockholder is liable severally to creditors, to the extent of the amount received by him; and that as between all stockholders similarly situated the burden of paying the debts shall be borne ratably". *Phillips-Jones Corp.*

[11] The stock admittedly constituted a "capital asset" as defined in Section 117(a)(1) and had been held for more than six months.

v. *Parmley,* 302 U. S. 233, 235-236. See also *Pierce v. United States,* 255 U. S. 398, 402-403.[12]

Both courts below properly viewed the payments here involved as discharging a transferee liability which the taxpayers incurred as a result of the exchange of their stock for the corporate assets. The payments were made in proportion to their former stock holdings, to a judgment creditor of the corporation. As the Tax Court observed, each of the taxpayers "was required to, and did, pay one-half of the judgment" (R. 6), against "a corporation of which they were transferees" (R. 6, 8). And in the words of the court below, the liability was "directly related to—and would not have existed except for—the capital distributions made by the corporation to those taxpayers in earlier years".[13] (R. 19.)

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[12] The law of the state (New York) in which the instant corporation carried on its business is in accord with this rule. *Bartlett* v. *Drew,* 57 N. Y. 587, 589; *Hastings* v. *Drew,* 76 N. Y. 9, 16; *Hazard* v. *Wight,* 201 N. Y. 399, 402-403. See also New York Stock Corporation Law, Secs. 15, 58, 58 McKinney's Consolidated Laws of New York, Annotated; New York Debtor and Creditor Law, Sec. 273, 12 McKinney's Consolidated Laws of New York, Annotated. Section 311(a) of the Internal Revenue Code provides a summary method whereby taxes imposed on a liquidated corporation may be collected from the transferee stockholders. *Phillips* v. *Commissioner,* 283 U. S. 589.

[13] Taxpayers' contention (Br. 9) that the court below disregarded the Tax Court's findings in relating the payments to the liquidation exchange arises from a misconception of the Tax Court's decision. The Tax Court here (R. 8) rested its

Since the liability which occasioned the payments arose from a capital transaction, the receipt of corporate assets subject to the liability in exchange for stock, the payments in satisfaction of that liability represent losses arising from an exchange and are subject to the capital loss limitations.[14] To hold that such payments are deductible as ordinary losses would defeat the express command in Section 23(g) that losses arising "from"

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decision on its reasoning in the *Switlik* case, *supra*, where it expressly recognized that the payments discharged a transferee liability resulting from the exchange, but considered itself foreclosed by the "annual accounting" rule from relating the payments to the exchange because they were made in a subsequent taxable year. As will be shown (pp. 27-36, *infra*) the Tax Court misapplied the annual accounting rule. Suffice it to note now that the court below did not disagree with any of the Tax Court's findings, which consist of a restatement of the stipulated facts. It merely dispelled the Tax Court's mistaken notion that, because the exchange and payments occurred in different years, it was precluded from associating the payments with the exchange. Moreover, whether a stockholder who receives the assets of a corporation in liquidation is subject to transferee liability for the corporate debts presents a reviewable question of law; even assuming that the Tax Court found no connection between the liquidation and the transferee liability, the court below would have been justified in rejecting such a finding.

[14] The Tax Court's failure to find that the losses arose from a sale or exchange, has no significance, contrary to taxpayers' contention (Br. 7, 9), in view of its erroneous belief that it could not associate the loss with the exchange for purposes of determining the nature of the loss. See fn. 13, *supra*. The Tax Court also made no finding that the loss did not arise from a sale or exchange.

sales or exchanges of capital assets are allowable only to the extent provided in Section 117. In substance and effect the post-liquidation payment of a corporate debt by a stockholder in discharge of transferee liability represents a refund of that portion of the corporate assets which was received subject to the debt. It results in an adjustment downward of the previously reported capital gain from the liquidation. *Milliken* v. *Commissioner*, 196 F. 2d 135, 139 (C. A. 2d), petition for certiorari pending, No. 185; cf. *Duveen Brothers, Inc.* v. *Commissioner*, 17 T. C. 124, affirmed *per curiam*, 197 F. 2d 118 (C. A. 2d), petition for certiorari pending, No. 210. See 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443 (1952); 64 Harv. L. Rev. 858 (1951). Stated in terms of the taxing statute, the "amount realized" by the stockholders from the "exchange" of their stock for the corporate assets (Sections 111(a), 115(c)) was reduced by the restoration of a portion of that amount in satisfaction of their transferee liability for the corporate debt; accordingly, they realized and reported a "long-term capital gain" from that exchange in the taxable years in which the liquidation distributions were received (Section 117(a)(4) and (b)), and sustained a "long-term capital loss" from the same exchange in the taxable year in which they relinquished part of the amount received in discharge of their transferee liability (Sections 23(g), 117(a)(5) and (b)).

Had the corporation paid all of its debts before or at the time of distributing its assets in liquidation, the payments would have simply diminished the amount received by the stockholders in exchange for their stock and, correspondingly, the long-term capital gain realized from the exchange. The effect is the same where, as here, the corporation first distributes its assets in liquidation and the stockholders are thereafter required to refund part of the amount received to a creditor of the corporation. In so far as the tax consequences are concerned, it makes no difference whether the liability of the stockholders for the corporate debt is expressly assumed or is imposed upon them by operation of law, or whether the debt was absolute or contingent at the time of liquidation, or whether it was asserted against the corporation at that time, or whether it is evidenced by a judgment. The important consideration is that the liability of the stockholders for the corporate debt arose directly from the liquidation exchange. *Milliken* v. *Commissioner, supra*; *Duveen Brothers, Inc.*, v. *Commissioner, supra.*[14a] Their post-liquidation pay-

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[14a] In the *Milliken* case, which involved the same question here presented, the court below reaffirmed its decision in this case and stated (196 F. 2d 135, 139):

> Here we are concerned rather with the nature of a loss to determine whether the ordinary loss or the capital loss provision governs. That the taxpayer could not reasonably have expected the expense cannot be permitted to obscure the fact that it was related to, and therefore

ments in discharge of that liability served merely to reduce the amount received (and the capital gain realized) from the exchange, just as if payment of the debt had antedated the exchange or had occurred simultaneously or within the same tax year.

Furthermore, to permit a stockholder to deduct as an ordinary loss the full amount of a corporate debt paid in satisfaction of transferee liability in years after the liquidation would in effect relieve him of tax on more than fifty percent of the capital gain actually realized from the exchange of the stock for the corporate assets, contrary to the mandate of Section 117(b).

An illustration based on the facts of this case will

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viewed practically was a reduction of, a previous capital gain or an increase of a previous capital loss. In the situation of transferee liability this is clearly the case, for by definition such liability stems from the liquidation distribution which, under I. R. C. § 115(c), 26 U. S. C. A. § 115(c), is a capital transaction. Neither the *Switlik* nor the *Bauer* case emphasizes the element of anticipation of the expense, and we find no sanction for it in the statute.

In the *Dwveen* case the Tax Court, in a decision affirmed by the court below on the authority of its decisions in this case and *Milliken*, held that a taxpayer who realized a capital gain from the sale of stock and in a later year was required to make payments to the purchaser in satisfaction of a guarantee, could deduct the payments as capital and not as ordinary losses. The rationale of the Tax Court's decision applies with full force here. While it there purported to distinguish the *Switlik* case, and here regarded that case as indistinguishable, we submit that they all present the same basic question.

bring the problem into sharper focus. Assume that prior to litigation a corporation has $125,000 of assets and $50,000 of liabilities, or net assets of $75,000; that the cost basis of the stock to its sole stockholder is $25,000; and that the stock has been held for more than six months. If the corporation pays its liabilities before distributing its assets in liquidation, or withholds an amount sufficient to pay them, the stockholder will realize a long-term capital gain of $50,000 (the excess of the $75,000 liquidation distribution over the $25,000 cost basis), of which $25,000 (fifty percent of the gain) is taken into account under Section 117(b) in computing net income. On the other hand, if the corporation distributes the assets undiminished by the amount of liabilities to which they are subject, and the stockholder thereafter pays the liabilities and deducts them in full as ordinary losses, the entire taxable gain will be erased. In such case the long-term capital gain on the liquidation will be $100,000 (the excess of the $125,000 liquidation distributions over the $25,00 cost basis, of which $50,000 (fifty percent of the gain) is taken into account under Section 117(b); but this previously reported gain will be entirely offset by the subsequent deduction of a like amount of corporate liabilities as an ordinary loss.[15] If, however, his

[15] In this illustration the entire amount of reported capital gain is eliminated by the subsequent deduction of the corporate liabilities. Whatever figures are used, however, the later

payment of the corporate liabilities of $50,000 is deducted as a capital loss, *i.e.*, only to the extent of $25,000, the result is that the taxpayer pays tax on $25,000, the correct amount of the net taxable gain.

Taxpayers' interpretation of the statute thus produces the incongruous and inequitable result that a capital gain, which would have been realized if the corporate liabilities had been satisfied prior to or at the time of liquidation, is reduced or (as in the illustration) entirely wiped out, if the transferee-stockholder pays the liabilities in a later year. Taxpayers argue, in effect, that Congress has afforded a ready means of tax avoidance by stockholders of a closely held corporation whose assets are subject to outstanding or contingent liabilities at the time of liquidation, especially in a case where as here the stockholders are aware of the liabilities at that time. Nothing in the statute or its legislative history suggests that such was the purpose of Congress. The Commissioner's interpretation, on the other hand, accomplishes a result that is both fair and in harmony with the terms and the general scheme of the statute. By according to the post-liquidation payment of the corporate liabilities the same capital status as the liquidation distributions received from the corpora-

deduction of the corporate liabilities as an ordinary loss will result in reducing the previously reported long-term capital gain by the amount of the liabilities.

tion, the percentage of the capital gain which must be taken into account under Section 117(b) remains constant whether the corporate liabilities are satisfied by the corporation or by the transferee stockholders, and whether they are paid before or after the corporate assets are distributed in liquidation.

The problem here is strikingly analogous to that presented in *United States* v. *Benedict*, 338 U. S. 692, where a trust took into account under Section 117(b) only fifty percent of capital gains in computing its taxable net income, and sought to deduct in full a charitable contribution made from such gains. This Court held that only fifty per cent of the charitable contribution—the proportionate part attributable to the taxable part of the capital gains—could be deducted. It stated (pp. 697-698) that to permit the deduction in full—

> would result in taxing the capital gains at substantially less than 50% of the amount at which they would be taxed if they were ordinary income. To the extent that the amount subject to tax goes below that percentage, it fails to give effect to the purpose of § 117 (b).

To sanction the deduction of the payments here involved as ordinary losses would likewise frustrate the purpose of Section 117(b), since it would result in taxing a capital gain at less than the percentage prescribed in that section.

D. The Losses Were Not Transformed from Capital Into Ordinary Losses Merely Because They Were Sustained in a Year Subsequent to the Liquidation Exchange

Had the payments in question been made in the same taxable year in which the liquidation distributions were received, they clearly would not have been deductible as ordinary losses. They would merely have reduced the capital gain realized by taxpayers in that year from the exchange of their stock for the corporate assets. The Tax Court assumed that because the payments were made in a year subsequent to the exchange, they must under the annual accounting rule be divorced from the capital transaction to which they are attributable and be allowed as ordinary losses.[16] In so assuming the Tax Court manifestly misconceived the meaning and purpose of the annual accounting rule.

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[16] Prior to *North American Oil* v. *Burnet*, 286 U. S. 417, the Tax Court had held that the payment of transferee liability in a later year required reopening of the stockholder's tax return and recomputation of his tax liability for the year in which the capital gain was reported. *Barker* v. *Commissioner*, 3 B. T. A. 1180; *O'Neal* v. *Commissioner*, 18 B. T. A. 1036. In *North American Oil* (and again in *United States* v. *Lewis*, 340 U. S. 590) this Court held that a taxpayer who receives income under a claim of right, and in a later year is required to restore part of it, may not reopen his return for the earlier year but may deduct the amount repaid in the year of repayment. Although the question here presented—whether the payment is deductible in the later year as an ordinary or capital loss—was not there involved, the Tax Court in the *Switlik* case, which it here followed (R. 8), considered itself precluded by the *North American Oil* decision from examining that question.

That rule is a sound and established one, and the Commissioner's position in this case is in no way inconsistent or out of harmony with the rationale of the annual accounting rule. Under our system of computing net income by annual accounting periods, taxpayers' returns for the years (1937-1940) in which they received the liquidation distributions under a claim of right may not be reopened to reflect the fact that in a later year (1944) they were required to restore a portion of the amounts received to a creditor of the corporation in satisfaction of transferee liability, nor has the Commissioner sought to reopen the earlier year's returns. The excessive amount received in the earlier years and refunded in the later year is deductible as a loss only in the year of repayment. *United States v. Lewis*, 340 U. S. 590; *North American Oil* v. *Burnet*, 286 U. S. 417. But the fact that the repayment is deductible in the later year does not determine whether it is deductible as an ordinary or a capital loss. The critical fact remains that the repayment discharged a transferee liability which flowed directly from a capital transaction, and hence was deductible in the year of repayment as a capital loss. As the court below stated (R. 20), the principle that each taxable year is a separate unit for tax accounting purposes and that a previous year's return may not be reopened to reflect later events—

> does not mean that an examination of the previous year's return may not be made in

> order to determine the nature of the new fact for the purpose of ascertaining how a gain or loss is to be categorized in computing taxable income for the year in which the new fact happened. So here, considering together the events of the previous year and of the taxable year, the loss in the taxable year show[s] up as arising out of a "sale or exchange."

Indeed here, if we accept the logical consequences of taxpayers' contention that their payment of the corporation's liabilities cannot be associated with the earlier distribution of the corporate assets to them, the paradoxical result would be, as will appear, *infra*, pp. 36-37, that the payments made by taxpayers could not be deducted at all, either as an ordinary or a capital loss.

The annual accounting concept requires that net income be computed and reported on the basis of a "fixed accounting period" known as a "taxable year"; it is designed to "produce revenue ascertainable, and payable to the government, at regular intervals". *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363, 365. See also *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *United States* v. *Lewis, supra; North American Oil* v. *Burnet, supra;* Internal Revenue Code, Sections 41, 42, 43 and 48. The concept has reference to *when* (the "taxable year") an income or deduction item must be accounted for in computing taxable net income, not to whether or how the item enters into the com-

putation. Accordingly, taxpayers accounting on the "cash" system must report income and deduct items in the respective taxable years in which they are received and paid; while those accounting on the "accrual" basis must report the items in the respective years in which the right to receive, or the obligation to pay, becomes fixed. "The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount." *Security Mills Co.* v. *Commissioner, supra,* pp. 286-287. But nothing in the annual accounting rule or its rationale forecloses an examination of events of a prior year in order to determine the character and tax effect of a receipt or payment in the current year. *Burnet* v. *Logan,* 283 U. S. 404; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Milliken* v. *Commissioner, supra; Duveen Brothers, Inc.* v. *Commissioner, supra; Commissioner* v. *Carter,* 170 F. 2d 911 (C. A. 2d); *Westover* v. *Smith,* [illegible] F. 2d 90 (C. A. 9th); *Winter Realty & Const.* [illegible] v. *Commissioner,* 149 F. 2d 567, 571 (C. A. 2d), certiorari denied, 326 U. S. 754; *Nichol* v. *United St*[illegible], 48 F. Supp. 662 (C. Cls.); *Megargel* v. *Commiss*[illegible], 3 T. C. 238; 64 Harv. L. Rev. 858 (1951); 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443

(1952); 38 A. B. A. J. 245 (1952). Cf. *Osenbach* v. *Commissioner* (C. A. 4th), decided July 24, 1952 (1952 P-H, par. 72553).[17] As Judge Learned Hand stated in the *Winter Realty & Const. Co.* case, *supra* (p. 571), "We agree of course, that the tax for every year must be separately assessed; but that does not mean that in computing the tax we may not look to what has happened in earlier

[17] In the *Osenbach* case there was a liquidation, pursuant to the stockholders' election, under Section 112 (b)(7) of the Code, which provides that out of the total amount of the gain realized on a distribution in complete liquidation, only that part of the gain shall be recognized, *i.e.*, be taxed, as represents accumulated earnings and profits, plus the money and stock and securities (acquired after a specified basic date) distributed in the liquidation. The liquidating corporation had no accumulated earnings and profits and distributed no money or stock and securities, with the results that none of the gain realized by the stockholders on the liquidation was taxable. There was no provision for taxing it at any other time, except insofar as it might be subjected to tax indirectly by reason of the fact that the basis for the assets acquired was required to take the basis of the stock surrendered in the liquidation unadjusted by the amount of gain on the exchange. The only question was whether the amount collected on claims received in the liquidation, the gain on receipt of which was entirely tax-free by virtue of Section 112 (b)(7), was taxable as ordinary income or as capital gain. The court held that it was taxable as ordinary gain since the claims were collected, not sold or exchanged. Unlike the instant case, there was there no payment which resulted in diminishing the gain (or increasing the loss) realized on the distribution in liquidation; thus there was no necessity to relate the amount collected to the gain realized and taxed on the liquidation to determine its nature as there is in respect of the subsequent payments in the present case.

years." It is quite common for a taxpayer to receive or pay amounts in one taxable year as a result of, or as one of several component steps in, a transaction which had its inception in a prior year. To compel the Commissioner and the courts to shut their eyes to the transaction which gives rise to the receipt or payment, merely because the receipt or payment occurs in a later year, would often render it impossible to determine its nature and tax effect. Indeed, by disconnecting the payment from the chain of events which preceded it, the payment is relegated to a statutory vacuum insofar as its tax consequences are concerned. Unless inquiry may be made as to the underlying transaction from which the liability to pay flows, no determination can be made of the character of the payment and its tax significance.[18]

[18] To take a simple example: A taxpayer contracts to purchase property in 1950, pays the purchase price in 1951, contracts to sell the property in 1952 for an amount exceeding its cost basis, and receives the selling price in 1953. The 1951 payment represents the cost of the property (a nondeductible capital expenditure), which is determinable only by relating the payment to the 1950 purchase. The 1953 receipt represents gain from the sale, includible in gross income only to the extent that it exceeds the cost basis of the property, which is determinable only by reference to the 1950 purchase, the 1951 cost, and 1952 sale. And whether the 1953 gain represents ordinary income or capital gain (and if capital gain, whether it is long-term or short-term) depends on whether the property was a capital asset and was held for more than six months prior to the sale, which are similarly determinable only by reference to the prior years' events.

Thus where stockholders receive liquidation distributions in successive taxable years the courts have treated the several distributions as interrelated parts of a single capital transaction, and accordingly have held that the future years' receipts represent additional capital gain rather than ordinary income. *Commissioner* v. *Carter, supra; Westover* v. *Smith, supra;* cf. *Burnet* v. *Logan, supra.*[19] No reason appears, and none is suggested by taxpayers, for treating the refund of an earlier year's capital receipts—the converse situation—as a separate transaction producing ordinary rather than a capital loss. If the liquidation is a continuing capital transaction where additional amounts are received by the stockholder in a later year, it ought not be regarded as a closed transaction where a part of the amount received is restored in a later year; by the same token, if additional receipts in a later year are includible in that year's income as capital gain, refund payments in a later year ought be deductible from that year's income as a capital loss. See 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443 (1952).

The decision below is not, as taxpayers charge, inconsistent with *Dobson* v. *Commissioner*, 320

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[19] In the instant case the liquidation distributions were received over several years (R. 5), and were reported and allowed in each year as capital distributions (R. 6). Yet it is only by relating the amounts received in each year to the original liquidation exchange that the distributions could properly be so treated.

U. S. 489, rehearing denied, 321 U. S. 231. On the contrary, the court below applied the very reasoning employed in that case in holding that the payments made in the taxable year represented capital losses. In the *Dobson* case purchasers of stock resold it at a loss, and in a later year recovered damages from the seller for breach of the sales contract. The Tax Court held that the purchasers realized no taxable gain in the later year, because the amount recovered was not sufficient to restore their original capital investment in the stock. The Court of Appeals reversed on the ground that the later year's recovery was a transaction separate and distinct from the earlier year's sale of the stock. This Court agreed with the Tax Court,[20] stating (pp. 493, 502-503):

> The Tax Court has not attempted to revise liability for earlier years * * *. It went to prior years only to determine the nature of the re-

[20] Upon petition for rehearing filed by two of the purchasers, whose recoveries were found by both lower courts to represent taxable income, this Court declined to hold as a matter of law that the recoveries constituted proceeds of a "sale or exchange" of a capital asset. 321 U. S. 231. This holding does not, as taxpayers assume, preclude a connection between what is concededly an exchange under Section 115(c) and the payment of transferee liability resulting directly from the exchange. See *Duveen Brothers, Inc., supra; Commissioner* v. *Carter, supra; Westover* v. *Smith, supra;* 64 Harv. L. Rev. 858 (1951). Nor does it detract from this Court's principal holding (320 U. S., at 493) that examination of a prior year's events may be made "to determine the nature of the recovery" (or a payment) in the later year.

> covery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital.
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> * * *
>
> The Government says that "the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation." But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. * * * The Tax Court analyzed the basis of the litigation which produced the re~~covery in~~ this case and the obvious fact that "regarding the series of transactions as a whole it is apparent that no gain was actually realized." * * * It concluded that the item should be treated as a return of capital rather than as taxable income.

In this case, however, the Tax Court made no attempt to analyze the nature of the payments in question, in order to determine whether they were deductible as ordinary or capital losses. Applying the theory it had adopted in the *Switlik* case, it held that the annual accounting principle as

a matter of law required their treatment as ordinary losses. In so holding it misapprehended the role which that principle plays in the taxing scheme.

E. If the Payments Are Disassociated from the Liquidation Exchange, They Are Not Deductible at All

If, as taxpayers contend, the payments are not deductible as capital losses under Section 23(g), they would not qualify for deduction as ordinary losses under Section 23(e)(2).[21] That section authorizes the deduction of losses incurred in a "transaction entered into for profit". To come within its provisions it is not enough for a taxpayer to show that the loss falls outside the capital loss provisions. He must affirmatively show that the loss is attributable to a "transaction entered into for profit" other than a sale or exchange of a capital asset.

The record and findings show, and both courts below held, that the payments in question discharged a transferee liability. If, as taxpayers maintain, the payments must be disassociated from the liquidation exchange and the resulting transferee liability, then the only transaction with which they could be associated disappears. And once the prior liquidation exchange and resultant transferee liability are excluded from consideration in deter-

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[21] The payments admittedly do not fall within Section 23(e)(1) or (3), which authorizes the deduction of business and casualty losses respectively.

mining the nature of the payments, there exists no basis for treating them either as ordinary losses deductible under Section 23(e) or as capital losses deductible under Section 23(g) since there would be nothing to show that they were incurred in a transaction entered into for profit. Indeed, they would not represent losses at all, but merely voluntary payments by the taxpayers, made without legal obligation, of a debt owed by another. *Sam P. Wallingford G. Corp.* v. *Commissioner,* 74 F. 2d 453 (C. A. 10); *A. Giurlani & Bro.* v. *Commissioner,* 119 F. 2d 852, 857 (C. A. 9); cf. *Welch* v. *Helvering,* 290 U. S. 111.

II.

Bauer's Payment of Half of the Amount of the Judgment Was of the Same Nature, and Is Subject to the Same Capital Loss Limitations, as Pogue's Payment of the Other Half

The judgment which was satisfied by the payments in question was rendered against the corporation and Bauer jointly. *Trounstine* v. *Bauer, Pogue & Co.,* 44 F. Supp. 767 (S. D. N. Y.), affirmed, 144 F. 2d 379 (C. A. 2d), certiorari denied, 323 U. S. 777. By reason of that fact Bauer contends that his payment of half of the amount of the judgment, as distinguished from Pogue's payment of the other half, satisfied a liability other than a transferee liability and consequently must be treated as an ordinary loss. The contention is erected upon a series of unwarranted assumptions.

1. In the first place, the judgment against Bauer was predicated, at least in part, on his liability as a stockholder-transferee of the corporation. The suit which resulted in the judgment was for an accounting of the profits of a joint venture relating to the sale of securities, entered into by the corporation and the plaintiff. Bauer and Pogue were made parties defendant as stockholders and directors of the corporation, but Pogue was not served and did not appear. 44 F. Supp., at p. 769. The District Court found that "Part of the assets of the corporation have been distributed to Bauer and Pogue, and its remaining assets still remain undistributed", *ibid.*, p. 769;[22] and that "In the distribution of the assets of the corporation, in which he [Bauer] undoubtedly shared, he has personally profited from the violation of the joint trading account agreement and was a party to such violation". *Id.*, p. 773. It held that Bauer "should, accordingly, be held jointly liable with the corporation". *Id.*, p. 773. The Court of Appeals agreed, holding that Bauer was "Jointly and severally liable with the corporate defendant". 144 F. 2d, at p. 382. Thus the judgment as against Bauer was based on the transfer to him of the corporate as-

[22] It has here been stipulated that the liquidation distributions began before the action was started, continued while it was pending, and were completed before the judgment became final; and that Bauer and Pogue each received distributions exceeding one-half of the amount of the judgment. (R. 17-18.)

sets, including the joint venture profits for which the corporation had failed to account, as well as on the fact that as president and co-owner he mismanaged the corporation.

By paying only one-half of the judgment, Bauer himself recognized that it was based on his liability as a transferee of the corporate assets. If, as he now suggests (Br. 17-18), the judgment as against him was founded principally on a different liability, he would have been obliged to pay its full amount, since no similar judgment was rendered against Pogue. Yet he and Pogue each paid one-half of the judgment, which corresponded with their former stock interests and their pro rata transferee liability. Bauer thus chose which liability he would satisfy, to his own advantage, and he cannot now be heard to say that he paid a different liability. Significantly, the Tax Court saw no difference in nature or tax effect between the payments made by Bauer and Pogue. It found that "each" of them "was required to, and did, pay one-half of the judgment" (R. 6) as "transferees" of the corporation (R. 6, 8). The court below likewise regarded Bauer's payment as basically "no different from that of the other transferee". (R. 20.)

In short, the suit was primarily one against the corporation for an accounting of the profits derived by it from a joint venture, and the liability of Bauer and Pogue as transferee-stockholders was

secondary to that of the corporation. Had the corporation complied with its agreement and accounted for the profits before distributing them in liquidation, neither Bauer nor Pogue would have received the excessive liquidation distributions which they were later required to restore to the judgment creditor of the corporation.

2. Secondly, while the judgment against Bauer was apparently also based on his misconduct as an officer of the corporation, it hardly would follow that his payment of one-half of the judgment is therefore deductible as an ordinary loss under Section 23(e), even if it were assumed *arguendo* that his payment was to satisfy partly his liability for misconduct. Even if the loss be viewed in this light, it was not incurred in his "trade or business" within the meaning of Section 23(e)(1); nor was it incurred in a "transaction entered into for profit" within the meaning of Section 23(e)(2), because the joint venture transaction which he mismanaged as an officer was entered into on behalf of and for the profit of the corporation, not for his own profit, and it was not incurred in *his* "trade or business". Even assuming, therefore, that Bauer was held jointly liable with the corporation solely because of his mismanagement of its affairs, his payment of one-half of the judgment would not be deductible by him as a loss at all, either as an ordinary or as a capital loss. Cf. *Stuart* v. *Commissioner*, 84 F. 2d 368 (C. A. 1st), certiorari

denied, 299 U. S. 575; *Reimold* v. *Commissioner*, 144 F. 2d 390 (C. A. 3d); *Clark* v. *Kavanagh*, 152 F. 2d 49 (C. A. 6th); *Hickey* v. *Chahoon*, 153 F. 2d 107 (C. A. 2d), certiorari denied, 328 U. S. 843; *Wigton* v. *Commissioner*, 13 T. C. 323; also cf. *Commissioner* v. *Heide*, 165 F. 2d 699 (C. A. 2d).[23]

3. Thirdly, whether or not Bauer had been joined as a party-defendant in the action against the corporation, he and Pogue would have been jointly and severally obliged as transferees of the corporate assets to satisfy the judgment against the corporation to the extent of the amounts they respectively received, and they each admittedly received an amount exceeding one-half of the judgment. (R. 5-6.) The most that may be said in Bauer's favor, therefore, is that his payment of one-half of the judgment served to extinguish *in toto* his transferee liability as a stockholder and *pro tanto* his tort liability as an officer. Since his payment of half of the judgment extinguished his pro rata transferee liability, it was in substance and for tax purposes no different from Pogue's payment of the other half and, like Pogue's pay-

[23] Even if Bauer's payment could be viewed as a loss arising from a joint venture entered into individually for his own profit, instead of from one entered into as agent of the corporation for the profit of the corporation, it still would not follow that the payment would be deductible as an ordinary rather than a capital loss. The joint venture was engaged in the sale of securities—capital transactions resulting in capital gains—and since the judgment was for an accounting of the gains, its satisfaction represented a capital loss.

ment, it is deductible as a capital loss. As the court below stated (R. 20):

> Here, however, Bauer was also liable, as a transferee, for the amount paid out, and that liability (we have held above) was an integral part of the original liquidation transfer, and so deductible as a capital loss only. We think, therefore, that the accidental fact that Bauer was liable both as an officer and as a transferee, did not give him the option of picking which liability he would satisfy, according to its tax consequences, when, as here, satisfaction of one liability discharged the other. For our purposes, the fact that he was personally liable for the judgment is superfluous; his fundamental position in regard to the 1944 payment was no different from that of the other transferee.

This reasoning is particularly persuasive, here, since there is nothing in the record to indicate that Bauer's payment was made with funds other than those transferred to him by the corporation. Indeed, there is no suggestion that at the time of the payment Bauer owned any assets other than those received upon liquidation of the corporation. He is scarcely in a position, therefore, to urge that his payment did not satisfy his transferee liability.

4. In any event, the Tax Court did not reach or pass upon the question of whether Bauer's payment should be treated differently from Pogue's. Viewing both payments as made in satisfaction of

transferee liability, it treated this case as presenting the same issue as the *Switlik* case. (R. 8.) The court below likewise viewed the two payments as essentially the same, and likewise treated this case as presenting the same issue as *Switlik*.[24] (R. 19.) Should this Court disagree with the holding of both courts below that Bauer's payment is in the same category as Pogue's for purposes of testing its deductibility, the case should be remanded to the Tax Court for a determination of whether and to what extent Bauer's payment, as distinguished from Pogue's, is deductible as either an ordinary or capital loss.

CONCLUSION

The judgment of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

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OCTOBER, 1952

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[24] The petition for a writ of certiorari in this case asserted direct conflict with the *Switlik* case, and because of the conflict the Commissioner did not oppose the granting of the writ.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

*   *   *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

*   *   *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

*   *   *

(g) *Capital Losses.*—

(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

*   *   *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

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(26 U. S. C. 1946 ed., Sec. 111.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. * * *

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(26 U. S. C. 1946 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [As amended by Sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

* * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(5) *Long-Term Capital Loss.*—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing net income;

* * *

(b) [As amended by Sec. 150(c), Revenue Act of 1942, *supra*] *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * *

(d) [As amended by Sec. 150(c) of the Revenue Act of 1942, *supra*] *Limitation on Capital Losses.*—

* * *

(2) *Other Taxpayers.*—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer or $1,000, whichever is smaller. * * *

* * *

(26 U. S. C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Revenue Code:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses; * * *

* * *

Sec. 29.23(g)-1. *Capital Losses.*—Section 23(g) provides in effect that deductions allowed to individuals under section 23(e) and to corporations under section 23(f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. * * *

* * *

Sec. 29.115-5. *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and section 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112, and shall be subject to the conditions and limitations provided in section 117.

* * *

The provisions of this section may be illustrated by the following examples:

Example (1). A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1931 at a cost of $1,500, and the remainder of 10 shares in December 1941 at a cost of $2,900. He receives in April

1942 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1931, and $2,500 on the 10 shares acquired in December 1941. The gain of $1,000 on the shares acquired in 1931 should be included in A's gross income to the extent of 50 percent, or $500; the loss of $400 on the shares acquired in 1941 should be deducted in computing A's net income to the extent of 100 percent, or $400. (See section 117.)

* * *

Sec. 29.117-2. *Percentage of Capital Gain or Loss Taken Into Account: Net Loss Carry-Over.* (a) *General.*—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117(b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. * * *

* * *

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NO. 51

IN THE

Supreme Court of the United States

OCTOBER TERM, 1952.

F. DONALD ARROWSMITH and RUTH R. BAUER, Executors of the Last Will and Testament of FREDERICK R. BAUER, Deceased, and RUTH BAUER, et al.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writs of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR EDGAR J. KAUFMANN AS AMICUS CURIAE.

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COMMISSIONER OF INTERNAL REVENUE, Respondent.

On Writs of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR EDGAR J. KAUFMANN AS AMICUS CURIAE.

Consent to File.

This brief *amicus curiae* is filed pursuant to Rule 27, Paragraph 9, of the Court's rules. The consent of the petitioners and of the respondent have been obtained and filed with the clerk.

Preliminary Statement.

This brief is filed for Edgar J. Kaufmann who, together with certain other taxpayers similarly situated, has now pending in the Court of Appeals for the Third Circuit a petition for review of a decision of The Tax Court of the United States in which the question involved is

similar to that presented for decision in the instant case. Edgar J. Kaufmann and the other taxpayers were formerly stockholders of Kaufmann Department Stores Securities Corporation which was merged in the year 1938 into Kaufmann Department Stores, Inc., by a statutory merger pursuant to which the stockholders of Kaufmann Department Stores Securities Corporation received stock of Kaufmann Department Stores, Inc., the surviving corporation in the merger. In the years 1943 and 1944, Edgar J. Kaufmann and his fellow stockholders paid certain liabilities of Kaufmann Department Stores Securities Corporation for federal income taxes and Pennsylvania corporate loans and corporate franchise taxes and penalties, assessed or asserted subsequent to the merger. The Tax Court held that the stockholders were entitled to deduct as losses in the years of payment a portion of the amounts so paid, but that such losses constituted capital losses, deductible only as such, rather than ordinary losses. *Edgar J. Kaufmann et al.*, 10 TCM 790. Petitions for review of the Tax Court's decision by the Court of Appeals for the Third Circuit were filed by the stockholders on April 18, 1952, and by agreement between the petitioners and the respondent, approved by the Court, further proceedings on the review have been held in abeyance pending the decision of this Court in the instant case.

While the *amicus curiae* agrees in general with the position of the petitioners in the instant case, it is felt that a further statement of the primary reason why it is considered that the payment of the judgment is deductible as an ordinary, rather than a capital, loss may be of assistance to the Court in disposing of the question presented.

Argument.

The court below has not controverted the fact that the liabilities paid by the petitioners in 1944 constituted deductible losses in that year but has held that they represented capital losses, deductible only to the limited extent provided by Section 23 (g) and Sections 117 (b) and (d) of the Internal Revenue Code. (26 U.S.C. 1946 ed., sections 23 (g), 117 (b), (d)). The sole question, therefore, is whether these admitted losses were losses "from sales or exchanges of capital assets" or "from the sale or exchange of a capital asset" within the meaning of Sections 23 (g) and 117 (a) (5). If they were not losses "from sales or exchanges of capital assets," they were deductible in full in the years sustained.

It is submitted that upon the basis of the facts of record the conclusion inevitably results that the petitioners' losses were not from sales or exchanges of capital assets within the meaning of Sections 23 (g) or 117 (a) (5) of the Internal Revenue Code. The exchanges upon the liquidation occurred and were completed in prior years and any gain or losses *from the exchanges* of capital assets occurred at that time, leaving no room for a loss from the exchanges at a subsequent date. In fact the petitioners derived gains from the distributions in liquidation which were properly to be reported, and taxable as such, in the years when the liquidating distributions were made. The assets acquired by the petitioners upon liquidation were received under a claim of right, without restriction as to their disposition. Under such circumstances, this Court has held that the income so derived must be returned for taxation in the year received, even though the taxpayer may later be adjudged liable to re-

store its equivalent. *North American Oil Consolidated v. Burnet,* 286 U. S. 417, 424.

The petitioners' deductible losses in the subsequent year were the result of a suit for an accounting, having no connection with the prior exchanges on liquidation, and the judgment procured by the plaintiff in that suit. This was a transaction separate from the liquidation exchanges and should be treated separately. If the suit had never been entered or if the plaintiff had been unsuccessful in the suit no loss would have resulted.

The court below held that the losses were capital losses on the ground that the losses in the taxable year "show up as arising out of a 'sale or exchange.'" If by this it meant to hold that the loss was from a sale or exchange within the meaning of the applicable sections of the Internal Revenue Code, its conclusion has no support in the facts of record and actually is contrary thereto. The petitioners' losses were related to their prior exchanges only indirectly in the sense that, if the petitioners had not received corporate assets on the exchanges, they would not have incurred the liability (disregarding for the moment the fact that the petitioner Bauer was liable both personally and as transferee). In a limited sense they arose as a result of the acquisition of the property upon the exchanges, rather than from the exchanges. But it is submitted that they were not losses from the exchanges within the meaning of the applicable sections of the Code, since the exchanges resulted in gains, taxable as such, and not in losses, and the losses in the subsequent year arose primarily from the successful prosecution of his claim by a creditor.

Where gains were involved in a subsequent year with respect to assets acquired on a prior liquidation exchange, the Commissioner of Internal Revenue has successfully urged that the principle of the identity and independence of each taxable year required that such gains be treated as ordinary income rather than from a sale or exchange. *Osenbach v. Commissioner of Internal Revenue*, 198 F. 2d 235 (C.A. 4th). A similar result should follow here with respect to losses. For the above reasons, without more, it is submitted that the court below erroneously held that the petitioners' losses were losses from the sale or exchange of capital assets deductible only to the limited extent provided by Section 117 of the Internal Revenue Code. Its decision on the basis of the stipulated facts is contrary to the law.

Respectfully submitted,

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Supreme Court of the United States

OCTOBER TERM, 1952

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Petitioners.

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE

JOHN W. BURKE,
Amicus Curiae.

JUDICIAL PRINTING CO., INC., 82 Beekman St., N. Y.—BEekman 3-9084-5-6

INDEX

CITATIONS

Cases

STATUTES

MISCELLANEOUS

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Opinions Below

The findings of fact and opinion of the Tax Court are reported in 15 T. C. 876 (R., pp. 4 to 8). The opinion of the Court of Appeals is reported in 193 Fed. (2d) 734 (R., pp. 19 and 20).

Jurisdiction

The opinion and judgment of the Court of Appeals were entered January 10, 1952 (R., pp. 19-21). A petition for rehearing was denied on February 11, 1952 (R., p. 24). The petition for writs of certiorari was filed on May 6, 1952 and was granted on June 9, 1952 (R., p. 25; 343 U. S. 976). Jurisdiction is conferred on this Court by Sec. 1254 of Title 28, United States Code.

Question Presented

Where a judgment against a dissolved corporation becomes final in 1944 and the former shareholders, as transferees, pay the judgment pro rata in 1944, the corporation having been dissolved and liquidated in the years 1937 through 1940, are the resultant losses capital losses?

Statement

The facts are set forth in pages 2 to 5 of petitioners' brief.

Summary of Argument

The judgment of the Court of Appeals now being reviewed held that the petitioners suffered a capital loss. This implies that the loss resulted from a sale or exchange. This is a question of fact which the Tax Court decided in favor of the petitioners herein, holding the loss was an ordinary loss. The Court of Appeals had no power to reverse this implicit finding of fact and nothing in the record supports the appellate court's finding. Policy considerations require that the Tax Court's determination be reinstated.

POINT I

The Court of Appeals erroneously made an implicit finding of fact contrary to the United States Tax Court.

Internal Revenue Code Section 117 (a) (5) defines a long term* capital loss as follows:

> "The term 'long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing net income;"

When the Court of Appeals held that the 1944 losses were capital losses, it necessarily decided that they resulted "from" a sale or exchange. It is clear that there was no sale or exchange in 1944. It is also clear that there were a series of exchanges from 1937 to 1940 (whereby petitioners received assets for their stock). The only question then was whether the 1944 loss was "from" the earlier exchanges. In other words, should the 1944 payments be regarded as a separate transaction or as a part of an integrated transaction beginning in 1937. This Court has held that this is a question of fact for determination by the Tax Court. In *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), rehearing denied 321 U. S. 231 (1944), this Court said:

> "* * * Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

---

* Short term capital losses are similarly defined except that the statute there refers to assets held for not more than 6 months, IRC Section 117 (a) (3).

Internal Revenue Code Section 1141 (a), as amended June 25, 1948, does not change this rule. Under Rule 52 of the Rules of Civil Procedure, the Court of Appeals may not substitute its judgment for that of the lower court in determining a question of fact. The appellate court can only reverse if the lower court's finding is "clearly erroneous".

POINT II

No facts support the decision of the Court of Appeals.

The 1944 payments can properly be regarded as adjustments to the 1940 liquidation exchange only if the 1940 liquidation was not a closed transaction.

This Court has already answered the basic question presented here, except that in the prior case the subsequent transaction involved a gain rather than a loss. In *Burnet* v. *Logan*, 283 U. S. 404 (1931), a taxpayer in 1916 had sold capital stock of an iron mine company for cash plus a royalty of all iron ore later mined. In later years taxpayer received these royalties as the ore was removed. The Commissioner claimed they were taxable to her as ordinary income. This Court held the payments were capital gain because the 1916 sale was not a closed transaction*, saying:

> "The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. *The transaction was not a closed one.*" (283 U. S. at 413, italics supplied.)

* Similar *facts* are required to keep a non-capital transaction "open" for the purpose of characterizing its consummation in a later year, see *Commissioner* v. *Smith*, 324 U. S. 177 (1945), at pages 181-2.

Thus the essence of the transaction was looking to the future. Even so this court relied on the fact of presently uncertainable value of the promised royalty to prevent the transaction from closing immediately.

Here, the essence of the earlier transaction was completion—liquidating and dissolving the corporation. Petitioners herein never agreed to pay Trounstine any amount to be fixed later. As the Tax Court pointed out, 15 T. C. at p. 878, the Trounstine claim was denied and actively resisted until 1944, four years after the liquidation was completed.

POINT III

The Tax Court's determination should be reinstated.

The rule which the Court of Appeals has asserted herein would keep every liquidation exchange open indefinitely. The only fact that Court relied on in reaching its decision is that the liabilities of the petitioners "would not have existed except for" the corporate liquidation, 193 Fed. 2d 734 at 735. In conflict with the workable rule of *Commissioner* v. *Switlik*, 184 Fed. 2d 299 (CA 3d, 1950), the respondent herein urges a rule which is first, dangerously impractical, and second, irrational.

It is dangerous because the same rule applied to gains is an invitation to widespread tax avoidance. Any corporation with assured prospects of substantial ordinary income could dissolve, and the shareholders would realize the income as capital gains which they "would not have received except for" the liquidation.*

* A recent volume contains the essay "How to Convert Ordinary Income to Capital Gain", Lasser, *Handbook of Tax Techniques*, Prentice Hall, 1951 (at page 788).

It is irrational because it adopts a *sine qua non* theory of proximate cause which is well known to be fallacious, as in tort cases.

We recognize clearly that the courts could prevent this theory from being carried to absurd extremes. But the prevention of abuse of this doctrine or of the contrary "Switlik" rule lies with the court which is to decide the facts in each case—here the United States Tax Court. That is the court Congress has designated to determine the facts and which can properly piece out a workable rule. Proper regard for good tax administration demands that the intermediate federal courts respect its function.

This Court has rightly stressed the importance of finality of the trial court's determination in this kind of problem. *Commissioner* v. *Culbertson*, 337 U. S. 733 (1949). The same method has been prescribed in *John Kelley Co.* v. *Commissioner*, 326 U. S. 521 (1946), and *U. S.* v. *Cumberland Public Service Co.*, 338 U. S. 451 (1950).

CONCLUSION

The United States Court of Appeals erred in reversing the Tax Court's determination because it implicitly substituted its contrary finding of fact without basis, in disregard of sound principles of judicial tax administration.

Respectfully submitted,

JOHN W. BURKE,
Amicus Curiae.

APPENDIX

Statutes and Regulations Involved

Internal Revenue Code

Sec. 117. Capital Gains and Losses.

(a) Definitions. * * *

(3) Short-Term Capital Loss.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income;

* * *

(5) Long-Term Capital Loss.—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months if and to the extent such loss is taken into account in computing net income;

* * *

Sec. 1141. Courts of Review.

(a) [As amended by Sec. 36 of the Act of June 25, 1948, c. 646, 62 Stat. 869.] Jurisdiction—The courts of appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code.

Rules of Civil Procedure for the District Courts of the United States as Amended

Rule 52(a)—Findings by the Court.

Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.* * *

Consents Pursuant to Rule 27 (9)

We hereby consent, pursuant to Rule 27 (9), that the above *amicus curiae* brief may be filed in this proceeding with the Supreme Court of the United States.

George R. Sherriff,
Counsel for Petitioners.

Robert L. Stern,
Acting Solicitor General,
Counsel for Respondent.

Supreme Court of the United States

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PETITION FOR REHEARING.

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Supreme Court of the United States

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

PETITION FOR REHEARING.

COME NOW the above-named Petitioners and present this their Petition for a rehearing of the above-entitled cause, and in support thereof respectfully show:

1.

The majority opinion effectively nullifies the previously well-established principle that each taxable year is a separate unit, and overrules the prior decisions of this Court establishing that rule.

The rule requiring annual accounting not only prevents the reopening of closed years, but also prohibits the striking of net results over several years. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Security Flour Mills Co.* v. *Com-*

missioner, 321 U. S. 281. The majority opinion strikes a net result over several years by treating the 1944 loss as reduction of the 1940 gain.

This is directly contrary to the *Sanford & Brooks* case where this Court prohibited use of the net result in a later year. There the transaction resulted in losses in earlier years. In a later year gain was realized from the same transaction and the taxpayer sought to strike a net result by applying the earlier year's loss to diminish the later year's gain. This Court stated the question to be

> "* * * whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion. * * *" (pp. 362, 363)

This Court refused to permit striking a net result from the beginning to the end of a given transaction over several years as violating the annual accounting rule, and said:

> "* * * A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss. * * * While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if

it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another." (pp. 364, 365, 366)

While the majority opinion does not reopen the earlier year it approves the striking of a net balance of the entire transaction in a later accounting year. It treats the later year's loss as diminution of the earlier year's gain. If this is correct it necessarily follows that a net result must be reached where, conversely, a loss in the earlier year is followed by gain in the later year, which reduces the earlier year's loss as in the *Sanford & Brooks* case. If the majority opinion is correct, the decisions in *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359; *Security Flour Mills Co.* v. *Commissioner,* 321 U. S. 281; *U. S.* v. *Lewis,* 340 U. S. 590; and *U. S.* v. *White Dental Manufacturing Co.,* 274 U. S. 398, have been incorrectly decided.

In the *Security Flour Mills* case this Court said:

"* * * In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust or unfair not to isolate the transaction and treat it on the basis of the long term result. We think the position is not maintainable. * * *" (p. 285)

The majority opinion here is in direct conflict with these cases.

The Commissioner has consistently sought enforcement of the annual accounting rule where it is to his advantage. *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359; *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281; *U. S. v. Lewis*, 340 U. S. 590. He should not be permitted to disregard this rule where in an isolated case, as here, it works to his disadvantage. *U. S. v. Lewis, supra.*

While not so specifying, the majority opinion reverses and nullifies said earlier decisions of this Court upon which the "well-established principle that each taxable year is a separate unit"(1) is founded. That "well-established" principle again becomes unsettled. The mandate of the *Lewis* case that this Court should not "depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer"(2) becomes meaningless.

The inevitable result will be further confusion and litigation which this Court must ultimately again determine. The problem should be put at rest here by continued consistent application of the annual accounting rule.

For the foregoing reasons it is respectfully urged that this Petition for rehearing be granted and that the majority opinion of the Supreme Court of the United States of November 10, 1952 be, upon further consideration, reversed.

Respectfully submitted,

George R. Sherriff,
Counsel for Petitioners,
42 Broadway,
New York 4, N. Y.

Joseph C. Woodle,
Of Counsel.

Dated: New York, N. Y., November 17, 1952.

---

(1) Majority Opinion p. 3.
(2) 340 U. S. at p. 592.

Certificate.

I, George R. Sherriff, Counsel for the above-named Petitioners, do hereby certify that the foregoing Petition for a rehearing of this cause is presented in good faith and not for delay.

George R. Sherriff,
Counsel for Petitioners,
42 Broadway,
New York 4, N. Y.